



## Financial Services & Products ADVISORY ■

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### CFTC Adopts Harmonization Rules for Registered Investment Companies

On August 22, 2013, the Commodity Futures Trading Commission (CFTC) issued [final rules](#) ("Final Rules") to harmonize the compliance requirements for advisers to registered investment companies who are also required to register as commodity pool operators (CPOs) with the CFTC (RIC CPOs).

Under the Final Rules, the CFTC generally will accept compliance with applicable securities laws and the SEC's regulations relating to disclosure, reporting and recordkeeping for registered investment companies (the "SEC Rules") as "substituted compliance" for compliance with the CFTC's Part 4 regulations. It is important to note that this "substituted compliance" regime means that any failure of a RIC CPO to comply with the applicable SEC Rules not only creates the potential for an SEC enforcement action, but it also creates the potential for a CFTC enforcement action as well.

On the day following the CFTC's adoption of the Final Rules, the SEC's Division of Investment Management published a Guidance Update titled "[Disclosure and Compliance Matters for Investment Company Registrants That Invest in Commodity Interests](#)," which summarized the views of the Division regarding certain disclosure and compliance matters relevant to funds that invest in commodity interests (the "Guidance Update"). The Guidance Update is intended to assist such funds in preparing disclosure filings and in their consideration of compliance issues, and largely reiterates past SEC staff guidance.

In addition to introducing the "substituted compliance" regime for RIC CPOs, the CFTC also amended certain provisions of its Part 4 regulations that are applicable to pools and accounts advised by CPOs and commodity trading advisors (CTAs), and provided relief for CPOs of commodity pools whose interests will be offered and sold pursuant to an effective registration statement under the Securities Act of 1933, (the "Securities Act").

Unless otherwise noted, the amendments set forth below are **effective as of September 23, 2013**.

#### **I. Background**

In February 2012, the CFTC amended CFTC Regulation 4.5, which generally provides an exclusion from the definition of CPO for operators of entities that would be "commodity pools" under the CFTC regulations, but that are already regulated by another regulatory authority, such as registered investment companies, banks, certain pension funds and insurance companies. Pursuant to this exclusion, operators of such regulated entities receive relief from CFTC registration as a

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CPO, and the regulated entities that they operate are exempt from CFTC disclosure, reporting and recordkeeping requirements. Under the amended Regulation 4.5, however, RIC CPOs are no longer able to claim an exemption from CPO registration if the registered investment company is marketed as a vehicle for trading in commodity futures or if it has more than de minimis exposure to commodity futures, commodity options contracts or swaps. Accordingly, unless otherwise exempt, it was proposed that RIC CPOs would be required to comply with the disclosure, reporting and recordkeeping requirements included in the CFTC regulations.

In amending Regulation 4.5, the CFTC recognized that CFTC and SEC requirements for dual registrants conflict in several material respects. In February 2012, the CFTC proposed amendments to its regulations to address these conflicts (the "Rule Proposal"). The Final Rule is significantly different from the Rule Proposal.

## II. Summary of Final Rules

### A. Delivery and Acknowledgement of Disclosure Documents

Prior to the publication of the Final Rules, CFTC Regulation 4.21 required a CPO to deliver a disclosure document to each potential investor and to obtain a signed acknowledgment of receipt of the disclosure document from each potential investor before accepting any funds from the investor. The SEC Rules, however, require delivery of a "statutory" prospectus to each registered investment company investor no later than the confirmation of the transaction and do not require signed acknowledgment prior to receipt of funds from an investor. In order to harmonize these requirements for RIC CPOs, the CFTC has determined to deem RIC CPOs compliant with the provisions of CFTC Regulation 4.21, provided that the CPO provides disclosure to potential investors consistent with SEC Rules. Accordingly, effective as of August 22, 2013, no CPOs are required to obtain a signed acknowledgement of receipt of the disclosure document prior to accepting investor funds. Moreover, any website permitted under the SEC Rules will also be deemed compliant with the provisions of CFTC Regulation 4.21.

### B. Expiration of Disclosure Documents

Previously, the CFTC regulations required CPOs and CTAs to update disclosure documents every nine months. For registered investment companies, the SEC Rules effectively require an annual update of registered investment company's registration statement and provide up to four months after the end of the registered investment company's fiscal year to file the annual update.

Under the Final Rules, **effective as of September 23, 2013**, RIC CPOs are exempt from the CFTC regulations relating to the update of disclosure documents, as long as they comply with the applicable registration statement update requirements set forth in the SEC Rules.

### C. Review of Disclosure Documents, Supplements and Amendments by NFA

Generally, CPOs are required to offer interests in commodity pools by use of a disclosure document that must comply with CFTC regulations 4.21, 4.24, 4.25 and 4.26. Regulation 4.26(d) requires a CPO to submit all disclosure documents to the National Futures Association (NFA), which must approve such disclosure document prior to any distribution to potential investors. Moreover, CFTC Regulation 4.26(c) requires a CPO to correct material inaccuracies in a disclosure document within 21 days of the date upon which the CPO first becomes aware of the defect. Any such amendment or supplement must also be filed with and approved by the NFA prior to use.

In the Final Rules, however, the CFTC states that although the CFTC has determined that the disclosures typically included in a disclosure document must be made available to the NFA during an examination, it will not be necessary to file disclosure documents, supplements or amendments with the NFA, and those documents will not be subject to NFA approval. Rather, a RIC CPO will be exempt from the updating and filing requirements included in the CFTC regulations as long as they comply with the SEC Rules regarding filing and approval for amendments and supplements to prospectuses. RIC CPOs that take advantage of this relief must file a notice with NFA **on or before October 21, 2013**.

#### **D. Disclosure Document Content**

Subject to certain exceptions discussed below, the CFTC has determined to deem RIC CPOs to be compliant with the provisions of CFTC regulations setting forth the requirements for the disclosures to be provided in a pool's disclosure document, provided that the registered investment company is in compliance with the analogous SEC Rules.

##### ***a. Risk Statements and Legends***

###### **i. The Standard Cautionary Statement**

Prior to the adoption of the Final Rules, CFTC Regulation 4.24(a) required that CPOs include a standard cautionary statement on the cover page of a pool's disclosure document. In the Rule Proposal, the CFTC proposed that, in lieu of the standard CFTC Regulation 4.24(a) cautionary statement, the cover page of a registered investment company's prospectus would be allowed to contain a statement combining the language required by CFTC Regulation 4.24(a) and Rule 481(b)(1) under the Securities Act.

In the Final Rules, however, the CFTC has determined that it would be acceptable for RIC CPOs to include the CFTC in the statement prescribed by the SEC under Securities Act Rule 481, so that the statement will 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

"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."

###### **ii. The Standard Risk Disclosure Statement**

CFTC Regulation 4.24(b) sets forth the standard risk disclosure statement required to be "prominently displayed" following the disclosures required to appear on the cover page of the disclosure document. The risk disclosure statement explains certain risks associated with the use of commodity interests, including discussions of liquidity, counterparty risk and other risks associated with swaps. In the Final Rules, however, the CFTC has determined to deem RIC CPOs compliant with CFTC Regulation 4.24(b) as long as the RIC CPO complies with applicable SEC Rules.

##### ***b. Break - Even Disclosure***

CFTC Regulation 4.24(d)(5) requires CPOs to include the "break-even point" in the forepart of the disclosure document. The CFTC regulations define 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."

The SEC Rules require disclosures regarding fees and expenses, but in a very different format. In the Final Rules, the CFTC stated that it was persuaded by commenters that the information required by the SEC achieves substantially the same purposes as the break-even point analysis, and accordingly, the Final Rules provide that RIC CPOs will be deemed compliant with the CFTC's break-even requirement as long as they are in compliance with the SEC Rules regarding disclosure of fees and expenses.

### *c. Past Performance Disclosure*

The CFTC requirements with respect to past performance disclosures are included in CFTC Regulation 4.25. The CFTC regulations require that CPOs disclose the following with respect to the offered pool: 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; 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. While the SEC Rules also require disclosure of past performance information, the specific performance disclosures and presentation are substantially different.

The CFTC regulations require additional disclosures for pools with less than a three-year operating history, including the past performance information for each other pool operated by the CPO. The SEC Rules do not require investment advisers to registered investment companies to disclose performance information for products other than the offered fund, and interpretations of such rules generally prohibit the presentation of the performance of any unrelated funds or accounts. The Guidance Update, however, affirms prior staff guidance that registered investment companies may include the performance of private accounts and other funds managed by the investment adviser that have "substantially similar investment objectives, policies and strategies," subject to certain limitations.

Under the Final Rules, for the most part, the CFTC will deem RIC CPOs to be in compliance with CFTC Regulation 4.25, as long as they are in compliance with the SEC Rules relating to past performance disclosure. However, the Final Rules do require that for CPOs of registered investment companies with less than a three-year operating history, the RIC CPO must disclose the performance of all accounts and pools that are managed by the RIC CPO that have investment objectives, policies and strategies substantially similar to the offered fund.

### *d. Compliance Dates for Disclosure Document Content*

While the Final Rules state that the new disclosure document requirements included in CFTC Regulation 4.12(c)(3) (i) are effective September 23, 2013, the adopting release for the CFTC's amendments to CFTC Regulation 4.5 stated that entities required to register due to the amendments to CFTC Regulation 4.5 would be subject to the CFTC Part 4 regulations within 60 days following the effectiveness of the final harmonization rules. In a letter (the "[ICI Letter](#)") to the director of the Division of Swap Dealer and Intermediary Oversight (DSIO), the Investment Company Institute has requested confirmation from the CFTC that:

1. for open-end registered investment companies, any initial registration statement, or post-effective amendment that is an annual update to an existing registration statement, that is filed **on or after November 22, 2013**, must comply with the new CFTC Regulation 4.12(c)(3)(i); and
2. for closed-end registered investment companies, any initial registration statement, or post-effective amendment that is required to update an existing registration statement, that is filed **on or after November 22, 2013**, must comply with the new CFTC Regulation 4.12(c)(3)(i).

## E. Recordkeeping

### *a. Location of Books and Records*

The CFTC regulations require that all CPOs maintain their books and records at the main business office of the CPO. The SEC Rules do not contain similar requirements for registered investment companies, and it is common for registered investment companies to maintain their books and records at the offices of third-party service providers. In the Final Rules, the CFTC determined to amend the CFTC regulations relating to the required location of books and records for all CPOs, and accordingly, as long as a CPO files a statement (the "Recordkeeping Delegation Statement") with the CFTC describing the delegated recordkeeper and maintains access to those records as required by the CFTC, the CPO will be permitted to utilize the services of third-party service providers with respect to the maintenance of books and records. The Recordkeeping Delegation Statement must be filed at the time that such CPO registers with the Commission, or delegates its recordkeeping obligations, whichever is later.

In the ICI Letter, the ICI noted that existing RIC CPOs that currently maintain their records with third-party recordkeepers would technically be unable to meet the timing requirements for the Recordkeeping Delegation Statement. The ICI letter explains that it is the ICI's understanding based on conversations with the CFTC staff that RIC CPOs will be deemed to have complied with the applicable Recordkeeping Delegation Statement requirements if the Recordkeeping Delegation Statement is filed **on or before November 22, 2013**. They have asked the CFTC staff to confirm.

Additionally, the ICI Letter points out that although the Final Rules state the CPOs may utilize third-party service providers for the maintenance of books and records as described above, many RIC CPOs currently maintain their books and records with third-party recordkeepers that are not explicitly listed in amended CFTC Regulation 4.23, including professional records maintenance companies, storage companies, sub-advisers and CTAs. The ICI claims that these RIC CPOs would "face an enormous burden if they were forced to transfer their books and records to the third-party recordkeepers that are permissible under amended Regulation 4.23 before the November 22, 2013 compliance date." The ICI Letter states that it is the ICI's understanding that the CFTC intends to further amend CFTC Regulation 4.23 to allow RIC CPOs to maintain required books and records with a broader list of third-party service providers, and that this further amendment will be effective prior to the November 22, 2013, compliance date.

### *b. Access to Books and Records for Inspection*

Under the CFTC regulations, CPOs are generally required to make the books and records of a pool available to investors for inspection. The SEC Rules do not include a similar requirement for registered investment companies. Under the Final Rules, as of August 22, 2013, RIC CPOs are exempt from the requirement to make the books and records of a registered investment company available to investors for inspection.

### *c. Investor Ledgers*

Currently, CFTC Regulation 4.23(a)(4) requires CPOs to maintain a ledger of each investor, showing such investor's name and address and all funds received from or distributed to such investor. This is not currently a requirement for registered investment companies.

Under the Final Rules, the CFTC has determined to deem RIC CPOs to be in compliance with the investor ledger requirement, as long as the CPO has a transfer agent or financial intermediary maintain records in such a way as to comply with the requirements set forth by the CFTC.

## F. Controlled Foreign Corporations

In a 2012 release, the CFTC previously explained that the wholly owned offshore subsidiaries (“controlled foreign corporations” or CFCs) often used by registered investment companies to gain exposure to commodities are, in its view, commodity pools and, unless they qualify for an exemption, their operators are subject to registration as CPOs.

Under the Final Rules, as long as a registered investment company provides full disclosure of material information regarding the activities of its CFC in its prospectus and/or other SEC filings, the CFC will not be required to separately prepare a CFTC disclosure document. Further, the Final Rules state that as long as the registered investment company consolidates the financial statements of the CFC with those of the registered investment company in the financial statements that are filed with the NFA, the CFC will not be required to file separate financial statements.

Further, on September 5, 2013, the CFTC DSIO issued no action relief (the “[No Action Letter](#)”) regarding the obligations of CPOs of CFCs to report under Part 4 of the CFTC’s regulations. In the No Action Letter, DSIO states that it will not recommend that the CFTC take an enforcement action against a CPO of a registered investment company that uses a CFC for the purpose of trading in commodity interests for failure to provide a report with respect to such CFC pursuant to CFTC Regulation 4.27(c) (which requires reporting on Form CPO-PQR) until the next applicable reporting period following the Compliance Date,<sup>1</sup> provided that:

1. the CPO of the CFC is also the CPO of the registered investment company;
2. the CPO provides a consolidated report for the registered investment company that includes that data for its CFCs to NFA pursuant to Regulation 4.27(c) for the next applicable reporting period following the Compliance Date; and
3. the CPO either:
  - a. currently consolidates the CFC’s financial statements with those of the registered fund for financial reporting purposes; or
  - b. is in the process of converting from separate financial reporting to consolidated financial reporting for the registered investment company and CFC, provided that:
    - i. the CPO operates at least one registered investment company that currently consolidates its CFC for financial reporting purposes; and
    - ii. such CPO’s other registered investment funds consolidate their CFCs for financial reporting purposes for the next applicable reporting period following the Compliance Date.

For all subsequent reporting periods after the Compliance Date, the CPO must either file a consolidated report consistent with the relief provided in the No Action Letter or make a separate filing on behalf of the CFC pursuant to CFTC Regulation 4.27(c).

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<sup>1</sup> “Compliance Date” is defined in the No Action Letter as being “the date upon which the CPOs of registered funds are required to comply with Part 4 of the Regulations following the adoption of a final rule harmonizing the [CFTC’s] compliance regime with that of the SEC.”

Additionally, the No Action Letter states that DSIIO will not recommend that the CFTC take an enforcement action against a CPO that uses a CFC to trade commodity interests for failure to distribute an annual report with respect to the CFC to the NFA pursuant to CFTC Regulation 4.22(c) provided that:

1. the CPO of the CFC is also the CPO of the registered investment company;
2. the CPO prepares an annual report of the registered investment company that contains consolidated audited financial statements for the registered investment company that includes, and also separately indicates, the holdings, gains and losses, and other financial statement amounts attributable to the CFC; and
3. the CPO submits such an annual report to the NFA, in lieu of a separate annual report of the CFC, for the next fiscal year of the registered investment company that ends after the Compliance Date and, going forward, for all subsequent fiscal years.

**The relief granted in the No Action Letter is not self-executing. In order to rely on the relief, eligible CPOs must file a claim consistent with the procedures set forth in the No Action Letter.** A claim will be effective upon filing, so long as the claim is materially complete. A claim with respect to CFTC Regulation 4.27(c) must be filed before the end of the next applicable reporting period following the Compliance Date, and a claim with respect to CFTC Regulation 4.22(c) must be filed by the end of the next fiscal year of the registered investment company that ends after the Compliance Date.

#### **G. Financial Statements**

CFTC Regulation 4.22 requires CPOs to distribute periodic Account Statements to each investor at least monthly for pools with net assets greater than \$500,000 and at least quarterly for all other pools. Under the Final Rules, however, the CFTC has provided relief to RIC CPOs from the requirement to send periodic Account Statements to investors, provided that the registered investment company's current net asset value per share is available to investors and provided that the registered investment company provides investors with semi-annual and annual reports and files periodic reports with the SEC as required by the SEC Rules. Further, the Final Rules allow RIC CPOs to provide financial information to investors through the website of the RIC CPO or a designee. The RIC CPO, however, will be required to submit a copy of the annual reports to the NFA within 90 days of a pool's fiscal year end. The amendments regarding distribution of financial statements became effective August 22, 2013.

#### **E. Form CPO-PQR**

The Final Rules state that RIC CPOs must comply with CFTC Regulation 4.27 (regarding the filing of Form CPO-PQR) on or before the date that is 60 days after publication in the Federal Register, which is **October 21, 2013**. The ICI Letter requests clarification that this means that **RIC CPOs will be required to file their first Form CPO-PQR with respect to the quarter ending December 31, 2013.**

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