August 14, 2013

CFTC Adopts "Substituted Compliance" Approach for Registered Investment Companies that Are Commodity Pools

By Kelley A. Howes and Jay G. Baris

In a dramatic change of course, the Commodity Futures Trading Commission (CFTC) adopted final rules that apply a "substituted compliance" approach for disclosure and compliance obligations of registered investment companies (RICs) that are also commodity pools. At the same time, the Division of Investment Management of the Securities and Exchange Commission (SEC) issued guidance to facilitate compliance with SEC and CFTC disclosure and reporting requirements by funds and their advisers that are subject to regulation by both agencies.

Last year, the CFTC modified its Rule 4.5 to exclude from the definition of a commodity pool operator (CPO) only those advisers of RICs that invest a *de minimis* amount of their assets in commodity interests other than for bona fide hedging purposes. An adviser that does not qualify for the exemption must register as a CPO, thus requiring the RIC to comply not only with existing SEC regulations but also with CPO disclosure, compliance and financial reporting obligations under CFTC rules. At the same time, the CFTC adopted the changes to Rule 4.5, it proposed rule amendments designed to "harmonize" the myriad of inconsistent regulations that would apply to RICs that are also commodity pools.

In public comment letters on the harmonization proposal, many market participants voiced the concern that the proposal did not go far enough and that RICs would still be subject to duplicative, inconsistent and possibly conflicting regulations. The CFTC listened. Its final harmonization rules are firmly grounded in the concept of "substitute compliance." That is, with some modifications, a CPO of a RIC that complies with the SEC's disclosure and compliance rules will be deemed to comply with CFTC regulations.

DISCLOSURE DOCUMENTS

Currently, a CPO can use a disclosure document dated no more than nine months prior to its use. Open-end investment companies may use registration statements that are up to 16 months old. The new rules provide that CPOs of RICs will be deemed to comply with CFTC disclosure obligations if they comply with the SEC's rules. The rules will not require CPOs of open-end RICs to submit their disclosure documents for separate review by the National Futures Association (NFA).

The CFTC requires that CPOs update disclosure documents to correct material inaccuracies within 21 days of the date they first learn of the defect. The SEC, in contrast, does not apply a specific schedule for corrections. Rather, the SEC generally prohibits the sale of shares of a RIC by means of a materially misleading prospectus and imposes liability for the use of such a prospectus. The CFTC has determined that compliance with SEC regulations will be adequate for CPOs of RICs.

© 2013 Morrison & Foerster LLP | mofo.com Attorney Advertising

DELIVERY OF DISCLOSURE DOCUMENTS

The CFTC will consider CPOs of RICs that comply with the SEC's prospectus delivery rules to have complied with the corresponding CFTC requirements. Unlike the CFTC, which treats a series trust as a discrete legal entity, the SEC allows series funds organized within a single trust to produce financial reports and disclosure documents on a series-by-series basis. The CFTC's final rules will accept compliance with the SEC's approach.

CAUTIONARY STATEMENTS

The CFTC will allow CPOs of RICs to use the cautionary statement prescribed in SEC Rule 481, with minor modifications, to comply with the requirements for cautionary legends on the cover page of commodity pool disclosure documents. Therefore, RICs must update their cover page disclosure to 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.

Commodity pools must also include standard risk disclosure in their disclosure documents regarding, among other things, the liquidity of commodity investments. The CFTC will not require RICs to comply with this disclosure requirement since open-end funds must honor redemption requests within seven days, and thus the CFTC's concerns related to liquidity are mitigated. Similarly, since closed-end funds generally trade on the open market, the risks of inability to redeem in a timely manner also appear mitigated.

DISCLOSURE OF BREAK-EVEN POINT

The CFTC requires commodity pools to disclose "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 CFTC originally proposed requiring this disclosure in RIC prospectuses. Commenters apparently persuaded the CFTC that the RIC fee table and other fee and cost disclosures, taken together, sufficiently communicate the fees and costs associated with a RIC that uses derivatives. The final rules do not require additional break-even point disclosure.

PAST PERFORMANCE DISCLOSURE

A CPO with less than a three-year operating history must disclose the past performance of each other pool it operates. Under the new rules, the CFTC will generally accept compliance with SEC requirements for disclosure of past performance. However, RICs with less than three years of performance history must disclose 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 CFTC believes that this disclosure obligation is consistent with SEC positions that permit – but do not require – disclosure of such similar accounts, and thus it should be consistent with SEC rules.

© 2013 Morrison & Foerster LLP | mofo.com Attorney Advertising

CONTROLLED FOREIGN CORPORATIONS (CFCS)

The CFTC specifically reaffirmed its position that RICs may continue to invest through CFC subsidiaries, but that the investment approach of a CFC may require its CPO to register, even if its parent RIC may rely on the Rule 4.5 exclusion. The CFTC said, however, that it will not require a separate disclosure document for a CFC because a RIC using that CFC to affect its investment strategy must disclose in its prospectus information about the RIC's investment in the CFC and the principal risks associated with the CFC investment. Moreover, if the RIC consolidates the CFC's financial statements with its own and files them with the NFA, the CFTC would not require the CFC to file separate financial statements.

ACCOUNT STATEMENTS

Current CFTC regulations require pools with net assets greater than $500,000 to send each participant monthly account statements containing specific information. Public commenters persuaded the CFTC to drop the monthly requirement, and to allow pools to rely on the SEC rules that require annual and semi-annual shareholder reports. The CFTC specifically noted that the use of electronic distribution of shareholder reports (e.g., through websites) would be acceptable.

BOOKS AND RECORDS

The CFTC dropped its proposal to require RICs to maintain full books and records at the CPO's main office. Rather, the CFTC amended its rules to allow all CPOs to use third-party service providers to maintain their books and records, as the SEC's rules now permit. Additionally, the CFTC is exempting RICs from CFTC requirements that books and records be made available for review and copying by individual shareholders. The CFTC recognized that transfer agents or other financial intermediaries may maintain these records with respect to omnibus accounts.

EXTENSION OF RELIEF TO OPERATORS OF OTHER POOLED INVESTMENT VEHICLES

- The CFTC extended relief to all publicly offered pools to the same extent as it applies to ETFs, regardless of whether those pools trade on an exchange.
- The CFTC did not extend relief to CPOs that manage privately offered pools, other than certain record-keeping matters.
- The CFTC rescinded the signed acknowledgment requirement for all registered CPOs, including those that offer private pools.
- The CFTC adopted, as proposed, a rule that allows all CPOs and commodity trading advisers to use a disclosure document dated no more than 12 months prior to the date of its use.

EFFECTIVE DATES

The harmonized compliance obligations for CPOs of RICs will generally become effective upon publication in the Federal Register. Compliance with the obligation to include certain past performance information will be effective 30 days after publication in the Federal Register. Initial reporting on forms CPO-PQR will begin 60 days after the date of publication.

© 2013 Morrison & Foerster LLP | mofo.com Attorney Advertising

ACTIONS REQUIRED

Under the new rules, a CPO of a RIC that wants to rely on the substituted compliance regime 4097must take the following actions:

- File notice of its use of the substituted compliance regime with the NFA;
- If it has less than three years operating history, disclose the performance of all accounts and pools managed by the CPO that have investment objectives, policies and strategies substantially similar to those of the offered fund;
- File with the NFA the financial statements that it prepares pursuant to SEC requirements; and
- File notice with the NFA if it intends to use third-party service providers for recordkeeping purposes.

OBSERVATIONS

The CFTC's final harmonization rules should come as a big relief to RICs and their investment advisers. The CFTC took a realistic approach, reflecting the practical difficulties in harmonizing two very different regulatory regimes, and recognized that the SEC is best positioned to protect investors in RICs that invest in commodity interests. The public comment process worked.

CONTACT:

Kelley A. Howes
(303) 592-2237
khowes@mofo.com

Jay G. Baris
(212) 468-8053
jbaris@mofo.com

Robert E. Putney, III
(212) 336-4451
rputney@mofo.com

Isabelle Sajous
(212) 336-4478
isajous@mofo.com

Luke T. Bagley
(212) 336-4379
lbagley@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for 10 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.

© 2013 Morrison & Foerster LLP | mofo.com Attorney Advertising