

CFTC Finalizes Harmonization Rules: Advisers to RICs Benefit From “Substituted Compliance” for Many Obligations

August 26, 2013

On August 13, 2013, the Commodity Futures Trading Commission (CFTC) adopted final rules to harmonize certain disclosure, reporting and recordkeeping obligations of commodity pool operators (CPOs) that are investment advisers to registered investment companies (RICs) with applicable federal securities laws.¹ The approach taken by the CFTC in the [Harmonization Rules](#) provides welcome relief to CPOs of RICs that would otherwise be facing major changes to operations and substantial administrative burdens in order to comply with all of the CPO compliance obligations and requirements under applicable CFTC and National Futures Association (NFA) rules.² Pursuant to the Harmonization Rules, the CFTC afforded relief to CPOs of RICs in the following key areas: (i) disclosure document requirements, (ii) reporting and (iii) recordkeeping. CPOs of RICs may elect to avail themselves of the relief afforded by the Harmonization Rules or comply with CPO obligations.³ If the former, a CPO of a RIC must claim the relief by filing a notice with the NFA. Notwithstanding the relief provided by the Harmonization Rules, advisers to RICs that are CPOs will still have to ramp-up quickly to comply with the requirements of the CPO regime that remain applicable.

1. Relief to CPOs Generally

In addition to the changes benefiting CPOs of RICs, the Harmonization Rules provide that all CPOs may use third-party service providers to maintain their books and records so long as the CPOs file a notice with the CFTC and the records remain readily accessible.⁴ According to the CFTC, this relief was issued in recognition of the technological advances in recordkeeping and the ability of market participants to make records readily available. In addition, (i) CPOs are no longer required to obtain a signed acknowledgment of receipt of a disclosure document from prospective investors in a commodity pool (e.g., prospective investors in a RIC that engages in commodity interest trading) and (ii) disclosure documents, going forward, will have to be updated by CPOs and CTAs every 12 months, rather than every nine months.⁵ Both of these changes are intended to reconcile CFTC requirements with other regulatory regimes to which many CPOs are subject. These changes have been well received by market participants because they significantly decrease operational and administrative burdens.

¹ The final harmonization rules are hereinafter referred to as the Harmonization Rules. The CFTC has identified the following as applicable federal securities laws: the rules and guidance of the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934 regarding disclosure, reporting and recordkeeping by RICs (collectively, the RIC Rules).

² The NFA is the self-regulatory organization to which the CFTC has delegated the registration of intermediaries, including CPOs and commodity trading advisors (CTAs).

³ Presumably choosing to comply with CPO obligations without claiming the relief would lead to difficulties because of conflicts and inconsistencies between CPO obligations and the RIC Rules.

⁴ The CPO recordkeeping requirements are described in Section 2.d. below.

⁵ The CFTC's disclosure document requirements are described in Section 2.b. below.

© 2013 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.

2. Relief Afforded to CPOs of RICs

a. Background

The Harmonization Rules were precipitated by changes made by the CFTC to the CPO and CTA regulatory regimes including, among other things, the significant narrowing of a previously broad exclusion from CPO registration under [CFTC Rule 4.5](#) that many advisers to RICs relied upon.⁶ Because of the changes to CFTC Rule 4.5, many advisers to RICs that were previously excluded from registration and regulation as CPOs have been required to register as CPOs if the RICs that they advise engage in more than a *de minimis* level of speculative futures, options or swaps (*i.e.*, commodity interest) trading.

When the CFTC first proposed harmonization rules in 2012, it acknowledged that imposing CPO compliance obligations on CPOs of RICs without also providing some relief would result in those CPOs being subject to conflicting, inconsistent or duplicative rules as they sought to comply with CFTC and SEC requirements. The Harmonization Rules are intended to resolve or ameliorate certain potentially conflicting disclosure, reporting and recordkeeping requirements for CPOs of RICs. The Harmonization Rules generally provide for “substituted compliance” for CPOs of RICs in that they deem a CPO to be in compliance with CPO disclosure, reporting and recordkeeping obligations if it (i) complies with the RIC Rules, and (ii) claims relief with the NFA.

The Harmonization Rules became effective on August 22, 2013. As a result, CPOs of RICs should anticipate having to comply with the CPO requirements, and the Harmonization Rules, in the near term.

b. Disclosure Documents

Currently, CPOs are required to deliver a disclosure document, which is akin to a prospectus, to all prospective investors in a commodity pool. Prior to accepting any funds from a prospective investor, a CPO must obtain a signed acknowledgment of receipt of a disclosure document from the prospective investor.

A disclosure document contains: (i) information pertaining to the investment objectives of a commodity pool, (ii) certain mandatory cautionary and risk disclosure statements, (iii) a description of principal risk factors and fee disclosures (including a break-even analysis, which informs investors in a commodity pool of the trading profit that a pool must realize in the first year of an investor’s investment to equal all fees and expenses such that the investor will recoup its initial investment) and (iv) past performance data. A CPO may not use a disclosure document that is more than nine months old and, in the event that there is a material inaccuracy in a disclosure document, such inaccuracy must be corrected within 21 days. Disclosure documents must be submitted to the NFA for review and approval prior to their first use.

Generally, all CPO obligations apply at the legal entity level. Therefore, a CPO may not prepare separate disclosure documents for commodity pools that are series of a trust, since they are not separate legal entities.

⁶ For more information, please see our February 29, 2012 [Legal Alert](#).

i. Detailed Explanation of Relief Afforded

The Harmonization Rules generally provide that a CPO of a RIC may comply with RIC Rules relating to prospectuses in lieu of having to comply with the CFTC's disclosure document requirements. Specifically, the Harmonization Rules provide the following:

- *Cautionary Statements.* CPOs of RICs may use one of the following modified cautionary statements, that combine CFTC and SEC requirements, in lieu of the CFTC's mandatory cautionary statement for disclosure documents:
 - *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.*
 - *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.*
- *Disclosure of Principal Risk Factors and Fees.* CPOs of RICs may comply with RIC Rules with respect to the disclosure of principal risk factors and fees in prospectuses in lieu of the CFTC's disclosure document requirements (including inclusion of the mandatory risk disclosure statement and break-even analysis).
- *Updating and Amending Disclosure Documents.* CPOs of RICs may comply with RIC Rules relating to the timing for updating and amending prospectuses in lieu of the CFTC's timing requirements for updating and amending disclosure documents.
- *NFA Review of Disclosure Documents.* CPOs of RICs are not required to submit disclosure documents to the NFA prior to their first use, provided that such documents are made available to the NFA during an NFA examination.
- *Disclosure of Past Performance Data.* CPOs of RICs are not required to provide past performance data in commodity pool disclosure documents *other than* in disclosure documents for commodity pools that have less than three years of operating history. For commodity pools with less than three years of operating history, a CPO of a RIC is required to disclose the past performance data of other commodity pools managed by the CPO that have investment objectives, policies and strategies that are substantially similar to the relevant commodity pool.
- *Use of Separate Disclosure Documents for Series of a Trust.* CPOs of RICs may use separate disclosure documents for commodity pools that are series of a trust, despite the fact that series of a trust are not separate legal entities.

The Harmonization Rules also (i) provide that the use of summary prospectuses by CPOs of open-ended RICs is permissible, provided that the relevant RIC Rules are complied with, and (ii) clarify that maintaining a current disclosure document is not required for RICs that are closed-end funds.

The CFTC's decision to permit CPOs of RICs to comply with the RIC Rules related to the use of a prospectus, in lieu of the CFTC's disclosure document requirements, is based on a determination by the CFTC that the RIC Rules afford disclosures and information that are commensurate with what is required under the CFTC's rules. Notwithstanding that the CFTC allows for substituted compliance, the failure by

a CPO of a RIC to comply with the RIC Rules will be treated by the CFTC as a violation of the CPO obligations under CFTC rules and could subject such CPO to a separate enforcement action by the CFTC.

In addition, CPOs of RICs also benefit from the relief afforded to all CPOs by the Harmonization Rules with respect to the acknowledgment of receipt of a disclosure document and the timing for updating disclosure documents.

Concurrent with the issuance of the Harmonization Rules, the SEC's Division of Investment Management issued guidance that is intended to facilitate compliance with SEC and CFTC disclosure and reporting requirements by CPOs of RICs (the [IM Guidance](#)). The IM Guidance indicates that the CFTC and the SEC worked together to harmonize the RIC Rules with CPO obligations concerning disclosures to investors so as to ensure that investors are provided with material information. The IM Guidance is intended to facilitate compliance with SEC and CFTC disclosure and reporting requirements and addresses four topics: (i) disclosures pertaining to derivatives and the risks associated with the use of derivatives, (ii) disclosure of performance data, (iii) inclusion of a cautionary statement that addresses both SEC and CFTC requirements (discussed above), and (iv) compliance and risk management.

c. Reporting

CFTC rule 4.22 requires CPOs to prepare and disseminate to investors in a commodity pool (i) an account statement, which must be delivered to investors on a monthly basis for pools with net assets in excess of \$500,000 and at least quarterly for all other pools, in each case 30 days after the end of the reporting period, and (ii) an annual report within 90 days after the end of the relevant commodity pool's fiscal year. The annual report must contain audited financial statements and must also be filed with the NFA. In addition, CPOs are required to complete, and submit to the CFTC, via the NFA, a Form CPO-PQR, in accordance with CFTC rule 4.27 (discussed below). The CPO reporting requirements are intended to increase transparency, both for investors and regulators, as to the financial condition of a CPO and the commodity pools that it operates.

The Harmonization Rules provide that, in lieu of the CFTC's periodic account statement requirement, CPOs of RICs may comply with reporting requirements under the RIC Rules (meaning delivery of annual and semi-annual reports to investors) so long as the RIC satisfies the following conditions: (i) the relevant RIC's current net asset value per share is made available to investors (including on an Internet website) and (ii) the RIC furnishes semi-annual and annual reports to investors and files periodic reports with the SEC as required by the RIC Rules.

The Harmonization Rules do not afford relief from the financial reporting requirements other than the periodic account statement requirement. Therefore, aside from meeting any reporting requirements under the RIC Rules, CPOs of RICs will be required to comply with all other relevant CPO financial reporting requirements, including preparing an annual report and Form CPO-PQR and submitting each to the CFTC, via the NFA.

i. Forms CPO-PQR and CTA-PR

As noted above, CFTC Rule 4.27 requires CPOs to file CFTC Form CPO-PQR with the CFTC, via the NFA, on a periodic basis. The frequency of such filings will depend on the assets under management of the CPO. CPOs of RICs were exempt from having to comply with this requirement pending the issuance of the Harmonization Rules. Now that the Harmonization Rules have been issued, CPOs of RICs will be required to comply with the CFTC Rule 4.27 requirements beginning on October 21, 2013, which is 60 days after the publication of the Harmonization Rules in the Federal Register

d. Recordkeeping

CFTC rule 4.23 requires CPOs to maintain comprehensive books and records, which must be kept at the CPO's main business office in an accurate, current and orderly manner. Such records include, but are not limited to, (i) detailed and itemized daily records of each commodity interest transaction for each commodity pool, (ii) all receipts and disbursements of money, securities and other property, (iii) a participant ledger detailing each commodity pool investor's name, address and all funds received from or distributed thereto, (iv) copies of each confirmation of a commodity interest transaction, and (v) all other relevant records. CPOs must make these records open to inspection and copying by investors. Like the reporting requirements, the CFTC's recordkeeping requirements are intended to facilitate transparency with respect to the financial condition of a CPO by ensuring access to key business records for investors and regulators.

CPOs of RICs will generally be required to comply with the CPO recordkeeping requirements. However, the Harmonization Rules exempt CPOs of RICs from having to make their books and records open to inspection and copying by investors, due to inconsistent requirements under the RIC Rules. In addition, CPOs of RICs benefit from the Harmonization Rules' change to allow all CPOs to use third-party service providers to maintain records.

e. Use of Controlled Foreign Corporations

The Harmonization Rules release addresses the use of controlled foreign corporations (CFCs) by RICs to meet their investment objectives. The CFTC takes the view that a RIC may continue to use CFCs. However, CFCs can fall within the commodity pool definition if they engage in commodity interest trading, thereby necessitating the registration of a CPO. Where this is the case, the Harmonization Rules provide that, if a RIC provides full disclosure of material information regarding the activities of its CFC through its obligations under the RIC Rules, the CFC will not be required to separately prepare a disclosure document. Moreover, if a RIC consolidates the financial statements of a CFC with its financial statements that are filed with the NFA, the CFC would not be required to file separate financial statements.

CPOs of RICs that use CFCs should take care to analyze how other CPO compliance obligations would apply with respect to CFCs that are commodity pools.

3. Compliance Dates

The Harmonization Rules became effective on August 22, 2013. As a result, the relief afforded by the Harmonization Rules, and the conditions for the relief, are now in place, with the exception of the following:

- *Disclosure of Past Performance Data.* With respect to the requirements relating to the disclosure of performance data by CPOs of RICs, compliance will be required (i) with respect to open-ended funds that are RICs, (a) upon the filing of an initial registration statement with the SEC or (b) the filing of the first post-effective amendment that is an annual update to an effective registration statement and (ii) with respect to closed-end funds that are RICs, (a) upon the filing of an initial registration statement or (b) when the closed-end fund is required to update its registration statement.
- *Form CPO-PQR.* As noted above, CPOs of RICs must begin complying with the CPO-PQR requirements under CFTC rule 4.27 beginning on October 21, 2013, which is 60 days following

the publication of the Harmonization Rules in the Federal Register. Accordingly, all CPOs of RICs will have to file a Form CPO-PQR commencing in 2014.

- *Broad Relief with Respect to Disclosure Document Updates and Recordkeeping.* The relief afforded with respect to the location of a CPO's books and records, and the change to the timing for updating disclosure documents from nine months to 12 months, will apply beginning on September 21, 2013, which is 30 days after the publication of the Harmonization Rules in the Federal Register.



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.

Frederick R. Bellamy	202.383.0126	fred.bellamy@sutherland.com
James M. Cain	202.383.0180	james.cain@sutherland.com
Robert S. Chase II	202.383.0194	robb.chase@sutherland.com
Robert E. Copps	212.389.5045	robert.copps@sutherland.com
Daphne G. Frydman	202.383.0656	daphne.frydman@sutherland.com
Gregory S. Kaufman	202.383.0325	greg.kaufman@sutherland.com
Michael B. Koffler	212.389.5014	michael.koffler@sutherland.com
John J. Mahon	202.383.0515	john.mahon@sutherland.com
David T. McIndoe	202.383.0920	david.mcindoe@sutherland.com
David A. Roby, Jr.	202.383.0137	david.roby@sutherland.com
Stephen E. Roth	202.383.0158	steve.roth@sutherland.com
Steven H. Scheinman	212.389.5043	steven.scheinman@sutherland.com
W. Mark Smith	202.383.0221	mark.smith@sutherland.com
Michael J. Voynich	404.853.8329	michael.voynich@sutherland.com
John H. Walsh	202.383.0818	john.walsh@sutherland.com
Warren N. Davis	202.383.0133	warren.davis@sutherland.com
Cynthia Reid Beyea	202.383.0472	cynthia.beyea@sutherland.com
Jeanette M. Curtis	202.383.0948	jeanette.curtis@sutherland.com
Raymond A. Ramirez	202.383.0868	ray.ramirez@sutherland.com
Stephen T. Tsai	202.383.0897	stephen.tsai@sutherland.com
William M. Watts, III	202.383.0898	bill.watts@sutherland.com