

CFTC Adopts Harmonization Rules Applicable To Registered Investment Companies That Do Not Rely On CFTC Rule 4.5

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Commodity Futures Trading Commission Rule 4.5 provides an exclusion from the definition of “commodity pool operator” (CPO) for, among others, certain registered investment companies that trade commodity interests. Between late 2003 and the beginning of 2012, all registered investment companies (RICs) were excluded from the definition of CPO. In February 2012, however, the CFTC amended Rule 4.5.¹ As amended, the Rule requires the investment adviser of a RIC to register as a CPO with the CFTC (such an adviser, an “IA-CPO”) if the RIC (i) trades more than a *de minimis* level of commodity interests or (ii) is marketed as a commodity pool (such a RIC, a “Commodity RIC”). An IA-CPO is required to comply with the Securities Laws and Commodity Laws.² Although the policies underlying the RIC and CPO regulatory regimes are similar, specific rules applicable to RICs and their investment advisers, on the one hand, and CPOs, on the other, have developed in parallel and have not been synchronized. As a

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result, many of the Commodity Laws applicable to an IA-CPO with respect to a Commodity RIC conflicted with the applicable Securities Laws. To address this issue, the CFTC did not require an IA-CPO to comply with the CFTC's disclosure, recordkeeping or reporting requirements with respect to a Commodity RIC until the CFTC adopted rules that harmonized, to the extent possible, these requirements with the requirements of the Securities Laws.³

On August 13, 2013, the CFTC adopted rules (the “Harmonization Rules”) that largely permit an IA-CPO to satisfy many of its Commodity Law obligations by complying with the Securities Laws applicable to RICs.⁴ The SEC's Division of Investment Management also issued guidance to facilitate compliance with SEC and CFTC disclosure and reporting requirements.⁵ Notably, no changes will be required to the content or format of a Commodity RIC's “summary” or “statutory” prospectus, with one exception regarding the inclusion of the past performance of other funds operated by, or accounts advised by, the IA-CPO if the offered Commodity RIC has an operating history of less than three years, as discussed below.

Unless noted otherwise, the amendments described below become effective on September 23, 2013. After a rule discussed in Section A, B or E of this memo-

randum (generally concerning disclosure update, delivery and content requirements) becomes effective, an IA-CPO seeking to rely on that rule will be required to comply with respect to: (i) a new open-end Commodity RIC,⁶ when it files an initial registration statement with the SEC; (ii) an existing open-end Commodity RIC, when it files its first post-effective amendment that is an annual update to an effective registration statement; (iii) a new closed-end Commodity RIC,⁷ when it files an initial registration statement with the SEC; or (iv) an existing closed-end Commodity RIC, when it is required to update its registration statement.

In most cases, the relief described herein must be claimed by the IA-CPO through a notice filing with the NFA.

Registered CPOs have compliance obligations in addition to those described in the Harmonization Rules. These areas include, among others, compliance with the CFTC's and NFA's marketing and advertising rules and NFA Bylaw 1101.⁸ IA-CPOs are also subject to examination by the NFA.

A. Disclosure Document Updates And Approval

CPOs are generally required to offer pool interests by means of a disclosure document that has been filed with the NFA for review and approval. The Commodity Laws currently require a CPO to update its pool

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disclosure document at least every nine months.⁹ In addition, a CPO must correct any material inaccuracies in a disclosure document within 21 days of the date the CPO first becomes aware of the defect. These updates and corrections must be submitted to and approved by the NFA prior to being distributed to prospective investors.

RICs are offered by means of a registration statement that has been filed with, reviewed by and declared effective by the SEC. The Securities Laws require an open-end RIC to update its registration statement at least annually, and provide up to four months after the end of the RIC's fiscal year in which to file the annual update. In addition, the Securities Laws prohibit the offer or sale of shares of a RIC by means of a materially misleading prospectus, and a RIC may file an amendment to its registration statement or supplement to its prospectus to update material information between annual amendment filings. The Securities Laws prescribe time frames in which an open-end RIC's registration statement amendment will become effective automatically. A RIC's registration statement and any amendment thereto must be filed with the SEC prior to becoming effective.

Under the Harmonization Rules, an IA-CPO will be exempt from the Commodity Laws' disclosure document update requirements if it complies with the applicable registration statement update requirements set out in the Securities Laws. In addition, an IA-CPO will not be required to submit the Commodity RIC's registration statement, amendments and supplements to the NFA for review or approval. Such documents must be made available to the NFA during an examination, however, to enable the NFA to discharge its oversight duties.

B. Disclosure Document Delivery – “Statutory” And “Summary” Prospectuses

Statutory Prospectuses

The Commodity Laws require a CPO to deliver a disclosure document to each investor prior to accepting funds from an investor. The Commodity Laws also describe the specific content that must be included in a disclosure document.

The Securities Laws generally require delivery of a “statutory” prospectus to each RIC investor no later than the confirmation of the transaction.

Under the Harmonization Rules, the IA-CPO of an open-end Commodity RIC will be exempt from the Commodity Laws' disclosure document delivery requirements if it complies with the delivery requirements of the Securities Laws. Because a CPO is

not required to maintain a current disclosure document for a pool that is not soliciting participants, an IA-CPO will also be exempt from the Commodity Laws' disclosure document delivery requirements with respect to a closed-end Commodity RIC, provided that it is operated in a manner consistent with its obligations under the Securities Laws.

Summary Prospectuses

The Commodity Laws do not permit a CPO to sell pool interests to retail investors by means of only a short-form or “summary” disclosure document.

The Securities Laws permit an open-end RIC to satisfy the disclosure document delivery requirement by delivering a “summary” prospectus to investors and providing the “statutory” prospectus, the statement of additional information, and the shareholder reports on a website (the address of which is provided on the cover of or at the beginning of the summary prospectus). The RIC must also provide paper copies of the “statutory” prospectus, statement of additional information and shareholder reports upon request at no cost to the requestor.

Under the Harmonization Rules, an IA-CPO will be exempt from the Commodity Laws' disclosure document delivery requirements if it delivers a “summary” prospectus to investors of an open-end Commodity RIC, provided the IA-CPO is in compliance with the disclosure document delivery requirements of the Securities Laws.

C. Disclosure Document Acknowledgement

The Commodity Laws historically required a CPO to obtain a signed acknowledgement of receipt of the disclosure document prior to accepting funds from an investor.

The Securities Laws have no equivalent requirement.

The Harmonization Rules eliminated this requirement, effective as of August 22, 2013. Thus, no CPO will be required to obtain a signed acknowledgement from its investors that a disclosure document has been received.¹⁰

D. Disclosure Documents for Commodity RICs With Multiple Series

Certain open-end RICs are organized and operate as series companies, with a single legal entity registrant that has multiple series or funds, each operating as a separate investment company.

The Commodity Laws generally require

that each pool be a discrete legal entity. Filings made under the Commodity Laws, therefore, may be required to be prepared at the legal entity, rather than the series, level.

The Securities Laws require reporting and disclosure on a series-by-series basis, but permit multiple series to be included in a single registration statement. Thus, an open-end RIC's registration statement may contain information regarding several funds.

Under the Harmonization Rules, the registration statement of an open-end Commodity RIC may continue to include information regarding multiple series consistent with the Securities Laws.

E. Content Of Disclosure Documents

Standard Cautionary Statements

The Commodity Laws require a standard cautionary statement to appear prominently on the cover page of the disclosure document that states that the CFTC has not passed on the merits of participating in the pool or on the adequacy or accuracy of the disclosure document. The cautionary statement must be included exactly as it appears in the Commodity Laws.

The Securities Laws require that the outside front cover of a RIC's prospectus contain a cautionary statement that states that the SEC has not approved or disapproved the securities or passed upon the accuracy or adequacy of the disclosure in the prospectus and that any contrary representation is a criminal offense.

Under the Harmonization Rules, an IA-CPO will be exempt from the CFTC-prescribed cautionary statement requirements if it provides a statement on the cover page of the Commodity RIC's disclosure document that combines the CFTC's and SEC's cautionary statements.¹¹

Standard Risk Disclosure Statements and Risk Disclosure

The Commodity Laws require standard risk disclosure statements to be included immediately following any disclosures required to appear on the cover page. These risk disclosure statements discuss risks associated with the use of commodity interests, including generic discussions of liquidity, counterparty creditworthiness, and limits on the ability to alter the terms of certain swap agreements. The standard risk disclosure statements must be included exactly as they appear in the Commodity Laws.

The Commodity Laws further require a discussion of the principal risk factors of participation in the offered pool. The discussion must include, without limitation, risks relating to volatility, leverage, liquid-

ity, and counterparty creditworthiness, as applicable to the trading programs followed, trading structures used, and investment activities of the offered pool. Such disclosure must appear in a single section of the disclosure document.

The Securities Laws do not require inclusion of prescribed risk disclosure statements on or immediately following the cover page of the disclosure document, other than the cautionary statement described above. They do, however, require disclosure of the principal and other risks associated with investment in a RIC and the extent to which the use of commodity interests creates such risks. Such disclosure must appear in an open-end RIC's "summary" and "statutory" prospectuses and may appear in various sections of a closed-end RIC's disclosure document.

Under the Harmonization Rules, no standard risk disclosure statements will be required to be included on or immediately after the cover page of a Commodity RIC's disclosure document. Moreover, an IA-CPO will be exempt from the Commodity Laws' specific risk disclosure requirements provided that the Commodity RIC complies with the risk disclosure requirements of the Securities Laws. The disclosure must include true, accurate and complete information describing the commodity interest activities of the Commodity RIC, including a discussion of the material risks of those assets and activities.¹² The risk disclosure must be tailored to the types of derivatives used by the Commodity RIC, the extent of their use, and the purposes for their use.¹³

Fee Disclosure and Break-Even Point Disclosure

The Commodity Laws require a CPO 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. The Commodity Laws also require a CPO to include in the "forepart" of the disclosure document the "break-even point" per unit of initial investment.¹⁴

The Securities Laws require similar disclosures regarding fees and expenses, but in a different format.

Under the Harmonization Rules, an IA-CPO will be exempt from the Commodity Laws' fee, expense and "break-even point" disclosure requirements if the Commodity RIC complies with the fee and expense disclosure requirements of the Securities Laws.

Past Performance Disclosure

The Commodity Laws require a CPO to disclose past performance information

including, but not limited to: (i) aggregate gross capital subscriptions to the pool; (ii) the pool's current net asset value; (iii) the largest monthly draw-down during the most recent five calendar years and year-to-date; (iv) the worst peak-to-valley draw-down during the most recent five calendar years and year-to-date; and (v) the annual and year-to-date rate of return for the pool for the most recent five calendar years and year-to-date. In addition, the Commodity Laws require a CPO to disclose the past performance of each other pool it operates when the offered pool has less than a three-year operating history.

The Securities Laws do not require a RIC to disclose past performance for any other fund or account.¹⁵ Most of the Securities Laws' other performance-related disclosure requirements, however, are similar to those required by the Commodity Laws, although presented in a different manner.

Under the Harmonization Rules, an IA-CPO will be exempt from the Commodity Laws' past performance disclosure requirements if the Commodity RIC complies with the past performance disclosure requirements of the Securities Laws. An IA-CPO of a Commodity RIC with less than three years of performance history, however, will also be required to disclose the performance of all accounts and pools that are managed by the IA-CPO and that have investment objectives, policies, and strategies substantially similar to those of the Commodity RIC.¹⁶

F. Controlled Foreign Corporations

Many RICs effectuate their commodity interest trading through a wholly owned controlled foreign corporation ("CFC"). The CFTC has taken the position that a CFC that trades commodity interests is a commodity pool even when it has only one owner. Thus, the adviser of the CFC will be required to register as the CFC's CPO, unless it qualifies for an exemption from registration. Under the CFTC's current interpretation, registration of the CFC's adviser as a CPO may be required even if the RIC that is the sole owner of the CFC is excluded from the definition of CPO under Rule 4.5 and thus, the RIC's adviser is not required to register as a CPO under Rule 4.5.

The Securities Laws require a discussion of the investment strategies of the RIC and the principal risk factors associated with investment in the RIC. If a RIC uses a CFC to effectuate its investment strategy, the RIC is required to disclose in its prospectus information about the RIC's investment in the CFC and the principal risks associated

with this investment and the underlying investments of the CFC, including those related to swaps and other commodity interests.

Under the Harmonization Rules, if a Commodity RIC provides full disclosure of material information regarding the activities of its CFC in its prospectus, the CFC's CPO will not be required to separately prepare a disclosure document that complies with the Commodity Laws. Moreover, provided that the Commodity RIC consolidates the financial statements of the CFC with its own financial statements filed with the SEC, and the IA-CPO also files them with the NFA, separate financial statements of the CFC will not be required to be filed with the NFA.¹⁷

G. Periodic Financial Statements

The Commodity Laws require a registered CPO to distribute to investors a periodic Account Statement that contains specified information. Commodity pools offered to retail investors generally distribute Account Statements each month.

The Securities Laws require open-end RICs to sell and redeem their shares based on the next-determined net asset values of those shares. Net asset values may be posted on the RIC's website or otherwise made available to investors. RICs are also required to furnish semi-annual and annual reports, including financial statements, to investors, as well as to file these reports and quarterly schedules of portfolio holdings with the SEC (which are publicly available to investors via the SEC's EDGAR system).

Under the Harmonization Rules, an IA-CPO will be exempt from the Commodity Laws' periodic Account Statement requirements provided that the Commodity RIC's current net asset value per share is available to investors, and that the Commodity RIC furnishes semi-annual and annual reports to investors and files these reports with the SEC as required by the Securities Laws. Financial information provided to investors may be made available through the website of the Commodity RIC or its designee. An IA-CPO, however, will be required to submit to the NFA a copy of the annual reports filed with the SEC.

This amendment became effective on August 22, 2013.

H. Certain Recordkeeping Obligations

Location of Books and Records

The Commodity Laws currently require that a registered CPO maintain all books and records at its main business office.

The Securities Laws do not have a similar requirement, and books and records are

often maintained at third-party service providers, such as the RIC's administrator or custodian.

The Harmonization Rules amend the Commodity Laws' books and records location requirements for all CPOs. As amended, any CPO may maintain its books and records either at its main business office or at the office of an administrator, distributor or custodian, or a bank or registered broker or dealer acting in a similar capacity.

The CPO must notify the NFA that its books and records will be maintained by an alternate recordkeeper. Such notice must include an undertaking from the recordkeeper that it will maintain the books and records in accordance with the Commodity Laws.

Making Books and Records Available to Pool Participants

The Commodity Laws generally require a CPO to make the books and records of a pool available to participants for inspection.

The Securities Laws do not have a comparable requirement. Access to books and records is instead governed by state law. Disclosure of non-public information to some, but not all, investors may be prohibited in some circumstances and/or may conflict with the adviser's fiduciary duties.

Under the Harmonization Rules, an IA-CPO will be exempt from the Commodity Laws' requirement that the Commodity RIC's books and records be made available for inspection by investors.

This amendment became effective August 22, 2013.

Ledgers Regarding Pool Participants

The Commodity Laws currently require a CPO to maintain a subsidiary ledger (or other record) for each investor that shows the investor's name and address, and all funds received from or distributed to the investor.

The Securities Laws do not have a comparable requirement for RICs. Transfer agents generally keep records of certain RIC investors. Since shares of RICs are often held through intermediaries, including in omnibus accounts, however, transfer agents do not have records on all RIC investors.

The Harmonization Rules amend the Commodity Laws such that the investor ledger requirement will be satisfied if the records of the Commodity RIC are maintained by a transfer agent. Where shares are held in omnibus accounts or through intermediaries, the transfer agent may maintain a list of such intermediaries that hold the Commodity RIC's shares.

I. Form CPO-PQR

Form CPO-PQR requires all registered CPOs to make annual and/or quarterly filings disclosing detailed information about

the CPO and its pools. An IA-CPO was not required to begin making Form CPO-PQR filings until after the Harmonization Rules were adopted.¹⁸ The first Form CPO-PQR

requirement applicable to an IA-CPO will be for the period ending December 31, 2013. The filing will be due March 31, 2014.

1. Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11252 (Feb. 24, 2012); correction notice published at 77 Fed. Reg. 17328 (Mar. 26, 2012). For more information, please see our client memorandum dated February 24, 2012, entitled CFTC Reinstates Restrictions on Registered Investment Companies (Agency Proposes Harmonization with SEC Rules at www.willkiw.com/files/tbl_s29Publications/FileUpload5686/4019/CFTC_Reins...

2. The term "Securities Laws" includes the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 (the "Investment Company Act"), the regulations promulgated by the SEC under those Acts, and any guidance issued by the SEC or any division thereof. The term "Commodity Laws" includes the Commodity Exchange Act, the regulations promulgated by the CFTC under that Act, any guidance issued by the CFTC or any division thereof and rules and guidance of the National Futures Association ("NFA").

3. For more information, please see our client memorandum dated March 27, 2012, entitled CFTC Proposes Harmonization Rules for Mutual Funds at www.willkie.com/files/tbl_s29Publications/FileUpload5686/4035/FDIC_Clari...

4. Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators, 78 Fed. Reg. 52308 (Aug. 22, 2013). In the Harmonization Rules, the CFTC also adopted certain rule amendments that apply to all registered CPOs (as opposed to just IA-CPOs of Commodity RICs).

5. Disclosure and Compliance Matters for Investment Company Registrants that Invest in Commodity Interests, IM Guidance Update 2013-05 (Aug. 2013) (the "IM Guidance"), available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-05.pdf>.

6. As used herein, the terms "open-end RIC" and "open-end Commodity RIC" include RICs and Commodity RICs, respectively, that operate as exchange-traded funds.

7. The CFTC staff published a no-action letter granting CPO registration relief to any operator of a closed-end management investment company that has elected to be regulated as a business development company ("BDC"), so long as the BDC trades only a de minimis level of commodity interests, among other things. CFTC No-Action Letter 12-40 (Dec. 4, 2012). The operator of a BDC that is unable to rely on CFTC No-Action Letter 12-40 may be required to register with the CFTC.

8. NFA Bylaw 1101 is a strict liability bylaw that generally prohibits any NFA member from doing business with another person who is required to be, but is not, registered with the CFTC. The NFA advised IA-CPOs that until further notice, Bylaw 1101 will not be applied to the investors of a RIC.

9. The Harmonization Rules amended the Commodity Laws for all CPOs to provide that a disclosure document may be used for up to 12 months before it must be updated. This amendment becomes effective on September 23, 2013, but is not relevant for an IA-CPO.

10. Please see the CPO Memo for more information.

11. The statement may read as 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." The SEC staff approved of this approach in the IM Guidance.

12. The SEC staff emphasized in the IM Guidance that a RIC should have policies and procedures in place that are sufficient to address (i) the accuracy of disclosures made about the RIC's use of commodity interests and the associated risks, and (ii) the consistency of the RIC's investments in commodity interests with the RIC's investment objectives. These policies and procedures should be reasonably designed, for example, to prevent material misstatements about the RIC's use of derivatives, including commodity interests, and the associated risks. In addition, a RIC's annual review required under the Securities Laws should assess the adequacy of such policies and procedures and the effectiveness of their implementation. The SEC staff noted that a Risk and Examinations Office has recently been created within the Division of Investment Management and is responsible for analyzing and monitoring the risk management activities of investment advisers and RICs.

13. See, e.g., the IM Guidance; Letter from Mr. Barry D. Miller, Associate Director, Office of Legal and Disclosure, U.S. Securities and Exchange Commission, to Ms. Karrie McMillan, General Counsel, Investment Company Institute (Jul. 30, 2010), available at <http://www.sec.gov/divisions/investment/guidance/ici073010.pdf>.

14. The Commodity Laws 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, as calculated pursuant to rules promulgated by [the NFA]." Although not specified in the Commodity Laws, the NFA has indicated in comments to individual registrants that it considers the "forepart" of the disclosure document to be the first three pages following the table of contents.

15. The SEC does not mandate the disclosure of the performance of other funds and accounts. The SEC staff indicated in the IM Guidance, however, that a RIC is generally permitted to show the performance of funds and accounts that are managed by the same investment adviser as the RIC and that have investment objectives, policies, and strategies substantially similar to those of the RIC. While not stated in the IM Guidance, in practice the SEC also looks for disclosure about how such related accounts differ from the offered fund. For example, the disclosure should discuss, among other things, whether the other account is a RIC, whether it is subject to the diversification requirements of the Investment Company Act, and how its fees differ from those of the offered fund.

16. The SEC staff noted in the IM Guidance that a RIC's adviser is responsible for ensuring that the performance history is not misleading. Thus, the registration statement should exclude the past performance of other funds or accounts only if the exclusion would not cause the performance history to be materially misleading. Note that the performance of other pools and accounts is not permitted to be included in the "summary" prospectus.

17. The SEC staff permits the consolidation of a CFC's financial statements with those of the RIC that owns the CFC. See, e.g., Fidelity Select Portfolio, SEC No-Action Letter (Aug. 29, 2008). The SEC staff has indicated in comments to individual registrants that such consolidation is required in certain circumstances.

18. For more information, please see our client memorandum dated February 17, 2012, entitled CFTC Adopts CPO and CTA Reporting Rules at www.willkie.com.