CFTC PROPOSES HARMONIZATION RULES FOR MUTUAL FUNDS

In connection with the recent adoption of amendments to Commodity Futures Trading Commission Rule 4.5, the CFTC has proposed amendments to its disclosure, recordkeeping and reporting rules. The proposed amendments are designed to resolve or minimize certain conflicts between CFTC rules and Securities and Exchange Commission rules applicable to registered investment companies whose futures and swaps trading subjects their advisers to regulation as CPOs. Generally, such amendments would provide relief only to an operator of a Futures RIC. Comments on the Proposal are due by April 24, 2012.

I. Prospectus/Disclosure Document Harmonization

CFTC rules generally require a registered CPO to deliver a “disclosure document” to each prospective pool participant, unless the CPO is exempt from such requirement with respect to such pool. The disclosure document must be prepared in accordance with CFTC rules and reviewed by the National Futures Association (“NFA”).

A. Delivery of Disclosure Document; Acknowledgment of Receipt

CFTC rules generally require that prior to accepting funds or other property from a prospective pool participant, a registered CPO must deliver a disclosure document to such prospective participant and receive a signed and dated acknowledgment of receipt. The SEC has no equivalent pre-delivery or acknowledgment requirements; instead, the federal securities laws generally require that the prospectus of an issuer, including that of a registered investment company (“RIC”), accompany the delivery of an investor’s purchase confirmation. Accordingly, the CFTC has proposed to exempt the CPO of a Futures RIC from the CFTC’s pre-delivery and acknowledgment requirements if such CPO (1) posts

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1 CFTC Rule 4.5, as amended, generally will have the effect of requiring investment advisers to certain futures- and swaps-trading registered investment companies (each, a “Futures RIC”) to register as commodity pool operators (“CPOs”) with the CFTC. As a registered CPO, each such adviser will generally be subject to the CFTC’s disclosure, recordkeeping and reporting requirements with respect to each such fund. For more information on the amendments to Rule 4.5, please see our client memorandum dated February 24, 2012, entitled “CFTC Reinstates Restrictions on Registered Investment Companies; Agency Proposes Harmonization with SEC Rules.”

2 Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators, 77 Fed. Reg. 11345 (Feb. 24, 2012) (the “Proposal”). Certain of the proposed amendments would also apply to pools whose units are offered pursuant to an effective registration statement under the Securities Act of 1933, as amended (“1933 Act”). The CFTC has granted similar relief to CPOs of commodity exchange-traded funds (“Commodity ETFs”). For more information on the relief granted to CPOs of Commodity ETFs, please see our client memorandum dated May 26, 2011, entitled “CFTC Adopts Relief for Commodity ETFs.”
the pool’s disclosure document on a website maintained by the CPO, (2) updates such disclosure document annually and (3) informs investors of the website address either directly or through the pool’s selling agents. Similar relief would be available to the CPO of any commodity pool registered under the 1933 Act.  

B. Legends

The CFTC generally requires that the cover page of any disclosure document prominently display a verbatim legend stating that the CFTC has not passed on the merits of investing in the offered pool or the adequacy or accuracy of the disclosure document. The SEC requires a substantively similar legend to appear on the cover page of a RIC’s prospectus but does not mandate the use of any specific language. The CFTC has proposed to permit the CPO of a Futures RIC to forgo the CFTC’s verbatim legend provided that a combined statement that satisfies the requirements of both agencies appears on the prospectus cover page.

C. Placement of Break-Even and Certain Other Information

The CFTC generally requires that certain information, including the pool’s break-even point, appear in the “forepart” of the disclosure document. Likewise, the SEC requires that certain information, including a fee table, appear in the summary section of a RIC’s prospectus. The SEC, however, requires that the summary section of the RIC’s prospectus be presented in a specific order and include only such information as specifically required by the SEC. To resolve this conflict, the CFTC proposes to permit information generally required to be in the “forepart” of a pool’s disclosure document to appear immediately after all SEC-required summary section disclosure.

The SEC permits an open-end RIC to fulfill its prospectus delivery requirement with a stand-alone summary prospectus. A summary prospectus contains information from the summary section of a RIC’s statutory prospectus and may be used if the statutory prospectus is available on a website specified on the cover page of the summary prospectus. Historically, the SEC has strictly limited the information permitted to be included in a summary prospectus. The CFTC-required disclosures presumably could appear only in the statutory prospectus that is available on the specified website, consistent with similar relief provided to CPOs of Commodity ETFs.

3 CPOs of privately offered pools would continue to be required to deliver disclosure documents and receive acknowledgments prior to selling any interests.

4 The “forepart” of a CFTC-required disclosure document is comprised of the pages “immediately following the table of contents.” Amendments to Commodity Pool Operator and Commodity Trading Advisor Disclosure Rules, 60 Fed. Reg. 38146, 38171 (July 25, 1995). The summary section of an SEC-required prospectus is generally considered to be the first three to four pages of the prospectus, although the SEC does not limit the number of pages for the summary section (or a stand-alone summary prospectus). Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 Fed. Reg. 4546, 4548, 4551 (January 26, 2009).
D. Fees and Expenses; Break-Even Table

The CFTC requires that certain fees and expenses, including brokerage commissions and portfolio transaction fees, as well as asset-based and incentive fees, be disclosed in a commodity pool’s disclosure document. The SEC also requires extensive fee disclosure in a RIC’s prospectus, although a RIC is not required to disclose specific brokerage commissions or portfolio transaction fees in its fee tables (such information is generally presented in the RIC’s statement of additional information).

The Proposal would require a Futures RIC prospectus to include any fees required to be disclosed by CFTC rules, as well as the tabular presentation of the pool’s break-even point, in addition to any fees required to be disclosed by SEC rules.5

E. Past Performance

The CFTC requirements with respect to the disclosure of past performance information differ significantly from the SEC requirements. The SEC requires a RIC to show its annual total returns only on a calendar-year basis, with the returns for the highest and lowest quarters and a table showing average annual total returns for 1-, 5- and 10-year periods (or since inception, if shorter), along with the performance of a broad-based securities market index. The CFTC requires a CPO to present in the main part of a pool’s disclosure document the pool’s (i) rate of return on a monthly basis, (ii) largest monthly decline during the most recent five calendar years and year-to-date and (iii) worst peak-to-valley decline during the most recent five calendar years and year-to-date.

In addition, if a pool has operated for less than three years, the CFTC requires the disclosure document to present the performance history of certain other pools and accounts operated by the CPO or commodity trading advisor. In contrast, the SEC generally discourages the presentation of past performance of other accounts with similar investment policies managed by a RIC’s adviser, permitting such disclosure only under limited circumstances. To resolve this conflict, the CFTC has proposed that, when required, the performance of other pools and accounts of the CPO and CTA may be presented in a Futures RIC’s statement of additional information.6

5 The CFTC proposes to require that the break-even table be included in the prospectus of a Futures RIC because, unlike the SEC-required fee tables and expense examples, the break-even table provides details regarding brokerage commissions and does not assume a specific rate of return.

6 The CFTC did not propose to provide this relief to other CPOs.
F. Periodic Updates

Currently, a disclosure document required to be filed with the NFA may be used for only nine months. Once the disclosure document expires, it may no longer be used to solicit investors, and must be updated and resubmitted to the NFA for review and approval. Neither CFTC nor NFA rules provide for a specific time limit within which a commodity pool’s disclosure document must be reviewed and approved. Although CPOs may distribute information to prospective investors prior to the approval of the disclosure document, such information must be consistent with or amended by the final approved disclosure document. The securities laws, on the other hand, effectively permit a prospectus to be used for a year before it must be updated. Moreover, although subject to SEC review, if there are no material changes from the previous year’s prospectus, the prospectus generally may be used immediately upon filing.

To resolve these conflicts, the CFTC has proposed to move to an annual update cycle for commodity pool disclosure documents. This change would be applicable to all CPOs. The CFTC has further proposed to permit the CPO of a Futures RIC with daily liquidity to simultaneously file the Futures RIC’s prospectus for review with the NFA and post such document on the CPO’s website, so long as the website version highlights any changes from the document’s most recent NFA-approved prior version. Once approved for use by the NFA, the final prospectus would have to be posted on the CPO’s website.

II. Reporting Harmonization

The CFTC generally requires that each registered CPO distribute an account statement on a monthly basis to each participant in each pool that it operates, unless the CPO is exempt from such requirement with respect to a specific pool. Such account statements must be presented as a Statement of Income (Loss) and a Statement of Changes in Net Asset Value.

The CFTC did not propose to exempt CPOs of Futures RICs from such reporting requirements. Instead, the CFTC proposed to permit the CPO of a Futures RIC to satisfy the account statement requirement by making account statements available on the CPO’s website within 30 calendar days after the last day of the applicable reporting period and for at least 30 calendar days thereafter.

CFTC-required account statements must also contain a verbatim oath or affirmation generally stating that the information contained in the document is accurate and complete. The oath or affirmation must be included in the monthly and annual reports provided to pool participants. In contrast, SEC-required shareholder reports, which contain the RIC’s full financial statements and are sent to shareholders, and quarterly reports, which contain only the RIC’s schedule of investments and are not sent to shareholders, require a verbatim certification stating in part that, based on the knowledge of the person making such certification, the statements in the document are accurate and complete.}\n
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7 Similar relief would also be extended to CTAs with respect to their disclosure document requirements.
the certification on behalf of the RIC (namely, the RIC’s CEO and CFO), the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made not misleading. Unlike the CFTC-required oath, the SEC-required certifications are not a part of the annual and semi-annual reports sent directly to shareholders, but instead are filed as exhibits to such reports submitted to the SEC’s public electronic document filing database (known as “EDGAR”).

To resolve this conflict, the CFTC proposed to accept the certification required by the SEC in lieu of the CFTC-required oath in a Futures RIC’s account statements if such certification is filed on EDGAR. 8

III. Recordkeeping Harmonization

The CFTC requires that a registered CPO prepare and keep the books and records of the CPO and each pool that it operates “at its main business office,” unless the CPO is exempt from such requirement with respect to such pool. The SEC, on the other hand, allows the books and records of a RIC to be prepared and maintained off-site, often at the offices of one or more of the RIC’s service providers.

Although the Proposal did not specify the conditions necessary for the CPO of a Futures RIC to claim relief from the requirement to maintain books and records on-site, the CFTC stated that such conditions would be consistent with those of the similar relief recently granted to CPOs of Commodity ETFs. In that context, the claim of exemption must generally identify each person who will keep the books and records, and identify the categories of books and records to be kept by such person. The CPO of a Commodity ETF also generally must represent in the claim of exemption that it (i) will promptly amend its filing if it becomes inaccurate, (ii) ultimately remains responsible for the books and records, (iii) will provide original books and records to the CFTC, NFA or Justice Department within 48 hours of any request and (iv) will disclose the location of the books and records in the fund’s disclosure document. The custodian of the Commodity ETF’s records must make similar representations, including a representation that the books and records will be made available to pool participants in accordance with CFTC rules.

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8 The Proposal did not address several other reporting conflicts. For example, the SEC-required certification must be made by officers of the RIC, whereas the CFTC-required oath or affirmation must be made by an officer of the pool’s CPO, which, in the case of a Futures RIC, will be the Futures RIC’s investment adviser. In addition, RICs generally have adopted very specific processes and procedures that must be followed before the SEC-required certification can be made. For a Futures RIC, such processes would have to be replicated by the adviser and completed on a monthly basis in order to provide the certification on the CFTC-required monthly reports (which are not currently required by the SEC). Compliance with these and other CFTC reporting requirements could increase compliance costs for Futures RICs and their advisers.
If you have any questions concerning the foregoing or would like additional information, please contact Rita Molesworth (212-728-8727, rmolesworth@willkie.com), Deborah A. Tuchman (212-728-8491, dtuchman@willkie.com), Dianne E. O’Donnell (212-728-8558, do’donnell@willkie.com), Jonathan Burwick (212-728-8108, jburwick@willkie.com), James Lippert (212-728-8945, jlippert@willkie.com), or the Willkie attorney with whom you regularly work.

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