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CFTC Curtails Commodity Pool Operator Exemptions for Registered Investment Companies and Private Funds and Commodity Trading Advisor Exemptions for Their Advisers

On February 9, 2012, the Commodity Futures Trading Commission (CFTC) issued final rules that will increase CFTC regulatory burdens for registered investment companies (RICs) and private funds that use any futures[1] or any swaps that are subject to the CFTC's jurisdiction.[2] The final rules significantly narrow the only exclusion from the definition of commodity pool operator (CPO) available to publicly offered RICs and eliminate two of the private fund industry's most heavily relied-upon exemptions from CPO and commodity trading advisor (CTA) registration.[3] The Final Rules also will subject registered CPOs and CTAs to new systemic risk reporting requirements.

In the preamble to the Final Rules, the CFTC suggests a broad reading of the "commodity pool" definition and, hence, the CPO registration requirement.[4] According to the CFTC, any operator of a pooled investment vehicle, public or private, that enters into even a single swap contract could trigger the CPO registration requirement.[5] This means that the operators of a number of entities that are not RICs or private funds, like real estate investment trusts (REITs) and business development companies (BDCs), also must consider whether they will be required to register with and be regulated by the CFTC as CPOs.[6] Similarly, advisers to such entities will need to consider whether they are required to register with and be regulated by the CFTC as CTAs.

Depending on a CPO's or a CTA's current status, the effective date for compliance with these new rules could be as soon as 60 days following publication of the Final Rules in the Federal Register or as late as December 31, 2012 (some aspects of the rules could be effective even later, depending on when final rules are adopted to define "swap" and to establish swap margin). Taken as a package, the Final Rules may well increase

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1 The CFTC's jurisdiction over futures also includes certain off-exchange transactions in foreign currency, more commonly referred to as "retail forex" transactions, between a party that is not an "eligible contract participant" (ECP) and a permissible counterparty listed in Section 2(c)(2) of the Commodity Exchange Act (CEA). 7 U.S.C. § 2(c)(2). The scope of this jurisdiction remains in question pending the final definition of ECP. *See* Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29818 (May 23, 2011).

2 These CFTC-regulated products include all financial futures, broad-based stock index futures, currency futures, and security futures as well as swaps on interest rates, currency, broad-based stock indexes and credit default indexes. However, the definition of "swap" does not include security-based swaps as defined in Section 3(a)(68) of the Securities Exchange Act of 1934 and also will be further defined by rules jointly adopted by the CFTC and the Securities and Exchange Commission (SEC). 15 U.S.C. § 78c(a)(68); *see* 76 Fed. Reg. 29818. Additionally, certain narrowly defined foreign exchange swaps and foreign exchange forwards may not be considered "swaps" if the Secretary of the Department of Treasury makes a written determination to exempt them. *See* 7 U.S.C. § 1(a)(47)(E); Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25774 (May 5, 2011).

3 Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 77 Fed. Reg. ___ (Feb. ___, 2012) (to be codified at 17 C.F.R. Pts. 4.5, 4.7, 4.13, 4.14, 4.24, 4.27, 4.34, 145, 147) (hereinafter the "Final Rules").

4 Final Rules, pgs. 24, 42.

5 *Id*.

6 The operators of entities like publicly traded REITs and BDCs will be ineligible for exclusion under Rule 4.5 or for exemption under Rule 4.13.

the number of CFTC registrants by the thousands and increase the reports filed with, and resources needed by, the CFTC concomitantly.

General Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) amended the CEA to add swaps to the CFTC's jurisdiction under a broad statutory definition.[7] To give effect to this expanded jurisdiction, Congress introduced or amended certain key definitions to the CEA, including the definitions of CPO and CTA.[8] A new statutory definition of "commodity pool" also was added; now a commodity pool is "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any … swap …"[9] These new definitions will become effective after the CFTC and the SEC jointly adopt final rules to further define the term "swap."[10]

The Final Rules go far beyond the Dodd-Frank Act's addition of swaps to CPO and CTA regulated activities and dramatically expand the CFTC's oversight of operators of, and advisers to, RICs and private funds that use any kind of "commodity interest"[11] by:

- Narrowing the CFTC Rule 4.5 exclusion from the definition of CPO for RICs by adding a trading restriction and a marketing restriction.
- Eliminating the often-used exemption from CPO registration under Rule 4.13(a)(4) for operators of privately offered funds whose participants satisfied certain investor sophistication requirements.
- Declining to grandfather any persons or entities that have claimed exclusions under Rule 4.5 or exemptions under Rule 4.13(a)(4).
- Rescinding the exemption from CTA registration available under Rule 4.14(a)(8)(i)(D) for advisers whose commodity interest advice is directed solely to a fund whose operator is exempt from CPO registration under Rule 4.13(a)(4).
- Narrowing the exemption from CTA registration available under Rule 4.14(a)(8)(i)(A) for advisers whose commodity interest advice is directed solely to RICs that can claim the (now narrower) exclusion under new Rule 4.5.
- Adding a new certification requirement for annual financial statements filed by CPOs claiming the partial CFTC Rule 4.7 exemption.[12]

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7 *See* Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010); 7 U.S.C. § 1a(47), 2(a)(1)(A) (as amended by the Dodd-Frank Act).

8 A CPO now is defined as "any person engaged in a business that is of the nature of a commodity pool … and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property … for the purpose of trading in commodity interests, including any … swaps …" 7 U.S.C. § 1a(11) (as amended by the Dodd-Frank Act). A CTA now is defined as "any person who…for compensation or profit, engages in the business of advising others … as to the value of trading in any … swap …" 7 U.S.C. § 1a(12) (as amended by the Dodd-Frank Act).

9 7 U.S.C. § 1a(10) (as amended by the Dodd-Frank Act). With the exception of the addition of swaps, this pool definition replicates the definition in Rule 4.10(d)(1) of the CFTC's existing rules. 17 C.F.R. § 4.10(d)(1).

10 Presently, the term "swap" in the Dodd-Frank Act has no effect in the statutory definitions of CPO and CTA by virtue of a CFTC exemptive order that is scheduled to expire on the earlier of July 16, 2012, or the adoption of a final rule by the CFTC and the SEC to further define the term "swap." Amendment to July 14, 2011 Order for Swap Regulation, 76 Fed. Reg. 80233 (Dec. 23, 2011). On January 11, 2012, the CFTC released a tentative rulemaking schedule anticipating the adoption of the final rules to further define "swap" during the first quarter of 2012.

11 "Commodity interest" includes futures, options on futures and certain retail forex transactions. The CFTC has proposed to amend this definition to include swaps. *See* 17 C.F.R. § 1.3(yy); The Adaptation of Regulations to Incorporate Swaps, 76 Fed. Reg. 33066 (Jun. 7, 2011).

12 Rule 4.7 does not exempt a CPO or CTA from CFTC registration. However, Rule 4.7 does partially exempt registered CPOs from certain CFTC disclosure, reporting and recordkeeping requirements and partially exempts registered CTAs

- Requiring that any person or entity claiming one of the remaining exclusions from the CPO definition or exemptions from CPO or CTA registration under Rules 4.5, 4.13 or 4.14(a)(8) file an annual notice with the National Futures Association (NFA) to renew its exclusion or exemption.

- Broadly imposing a systemic risk reporting requirement, in the form of Forms CPO-PQR and CTA-PR, on the operators and advisers of private funds and RICs that are required to register as CPOs and CTAs, or in the form of the SEC-CFTC jointly adopted sections of Form PF if the CPO or CTA also is a private fund adviser required to file Form PF.

I. RICs and Their Advisers

How Do the Final Rules Impact RICs?

The Final Rules impose two restrictions — a trading restriction and a marketing restriction — on RICs seeking to rely on Rule 4.5's exclusion from the CPO definition. A RIC will need to comply with both restrictions in order to claim the exclusion under Rule 4.5. These restrictions do not apply to any of the other categories of "qualifying entities" that may claim exclusion under Rule 4.5.[13]

Trading Restriction Under Rule 4.5

Under the trading restriction, there is no limit on the amount of positions in commodity futures, commodity option contracts[14] or swaps that a RIC can hold, as long as such positions are used for "*bona fide* hedging purposes" within the "meaning and intent" of Rules 1.3(z)(1) and 151.5.[15] The bona fide hedging definition is quite restrictive and many risk management strategies will not be included.[16] For non-*bona fide* hedging positions, a RIC's use of futures and swaps must satisfy either of the following two measures:

- The aggregate initial margin[17] and premiums required to establish the RIC's positions in any futures and swaps must not exceed 5 percent of the liquidation value of the RIC's entire portfolio (after taking into account the unrealized profits and unrealized losses on any such contracts);[18] or

- The aggregate net notional value of the RIC's positions in any futures and swaps must not exceed 100 percent of the liquidation value of the RIC's entire portfolio (after taking

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from certain CFTC disclosure and recordkeeping requirements. 17 C.F.R. § 4.7. Rule 4.7 will not exempt registered CPOs or CTAs from filing Form CPO-PQR or CTA-PR. The applicability of Rule 4.7 will be discussed in Skadden's webinar on these rule changes (time and date to be announced).

13 However, in the preamble to the Final Rules, the CFTC states that "if it becomes aware of any other categories of qualifying entities engaging in similar levels of derivatives trading, it will consider appropriate action to ensure that such entities and their derivatives trading activities are brought under the CFTC's regulatory oversight." Final Rules, pg. 15.

14 Although the final rule text lists these products as if they were separate, the CFTC has declared that commodity options are subsumed within the statutory definition of "swap." *See* Commodity Options and Agricultural Swaps, 76 Fed. Reg. 6095, 6097 (Feb. 3, 2011).

15 Final Rules, pg. 19.

16 *See* Skadden's November 18, 2011 Client Alert (pgs. 9-10) for a summary of new Rule 151.5 and the *bona fide* hedging definition.

17 The CFTC relies on "aggregate initial margin" despite the fact that swap margin requirements are still unknown. Indeed, neither the CFTC nor other regulators have finalized rules that would establish uncleared swap margin requirements, and the CFTC only recently finalized other rules governing collateral treatment and clearinghouse core principles that are expected to cause clearinghouses to impose high (but currently unknown) levels of margin on cleared swaps. *See* Margin Requirements for Uncleared Swaps for Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (Apr. 28, 2011); Protection of Cleared Swaps Customer Contracts and Collateral, 77 Fed. Reg. 6336 (Feb. 7, 2012).

18 The in-the-money amount of an option that is in-the-money at the time of purchase may be excluded; CFTC Rule 190.01(x) provides a definition for the "in-the-money" amount. 17 C.F.R. § 190.01(x).

into account the unrealized profits and unrealized losses on any such contracts), determined at the time the most recent position was established.[19]

In determining aggregate net notional value, the Final Rules allow a RIC to net the same types of futures contracts across different exchanges.[20] The Final Rules also state that a RIC may net swaps that are cleared on the same derivatives clearing organization, "where appropriate."[21]

There is considerable ambiguity as to how the aggregate net notional value test will be applied. As proposed, the trading restriction did not include, or provide an opportunity for comment on, an aggregate net notional value test.[22] The CFTC stated that it added the aggregate net notional value test as an alternative to the aggregate initial margin test in order to provide flexibility to RICs "in consideration of the fact that initial margin for certain commodity interest products may not permit compliance with the [5%] threshold."[23] Yet, the Final Rules leave questions as to the frequency with which the aggregate net notional test should be applied to a RIC's portfolio and what a RIC should do in the event that an intraday market movement causes it to temporarily exceed a threshold.

Marketing Restriction Under Rule 4.5

Under the marketing restriction, a RIC may not market itself to the public as a commodity pool or as "a vehicle for trading in the commodity futures, commodity options, or swaps markets." In the preamble to the Final Rules, the CFTC included a non-exhaustive list of factors that will be indicative of commodity pool marketing:

(i) The name of the RIC (*i.e.*, whether the name suggests the RIC is a vehicle for trading futures or swaps);

(ii) Whether the RIC's primary investment objective is tied to a commodity index;

(iii) Whether the RIC makes use of a controlled foreign corporation (CFC) for its derivatives trading;

(iv) Whether the RIC's marketing materials — including its prospectus — refer to the benefits of using derivatives in a portfolio or make comparisons to a derivatives index;

(v) Whether, during the course of its normal trading activities, the RIC or an entity on its behalf has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives;

(vi) Whether transactions in futures or swaps engaged in by the RIC or on behalf of the RIC will directly or indirectly be its primary source of potential gains (losses); and

(vii) Whether the RIC is explicitly offering a managed futures strategy.

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19 For purposes of the aggregate net notional value test, the notional value of a RIC's positions are calculated differently for each type of instrument: futures, commodity options, or swaps. Final Rules, pg. 121. The new Rule 4.5 also requires the notional value for cleared swaps "to be determined consistent with the terms of part 45 of the CFTC's regulations." Final Rules, pg. 121. However, Part 45 does not specify how to calculate the notional value of a swap, addressing instead the reporting of valuation data to a swap data repository.

20 Final Rules, pg. 121. For example, a futures contract on a 10-year U.S. Treasury Note on Exchange A could be netted with a futures contract on a 10-year U.S. Treasury Note on Exchange B.

21 Neither the Final Rules nor the preamble explain when it is "appropriate" for swaps cleared on the same clearinghouse to be netted.

22 Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 76 Fed. Reg. 7976, 7989 (Feb. 11, 2011).

23 Final Rules, pg. 16. The CFTC also said that it adopted the aggregate net notional value test as an alternative to permit RICs to exceed the activity allowed by the aggregate initial margin test. *Id.*

The CFTC said it will give the final factor the most weight, but that no one factor is dispositive. Accordingly, it is possible for a RIC not to offer a managed futures strategy and still be found to have violated the marketing restriction. In addition, factors (v) and (vi) consider the actual trading of the RIC and, thus, could conceivably cause a RIC trading within the permissible limit (perhaps close to the amount allowed by the aggregate net notional value test), but not otherwise marketing itself as a commodity pool, to violate the marketing restriction by virtue of its trading activities. The CFTC stated, however, that disclosure of the mere fact that a RIC may engage in derivatives trading incidental to its main investment strategy or disclosure of the associated risks would not violate the marketing restriction.

As proposed, the marketing restriction would have included additional language that would have prevented a RIC from marketing itself as "a vehicle for trading in *(or otherwise seeking investment exposure to)* commodity futures, commodity options, or swaps markets."[24] In response to several comments, the marketing restriction in the Final Rules does not include the parenthetical phrase "or otherwise seeking investment exposure to." While the omission of this language has alleviated some of the concern over the ambiguity of the marketing test, the CFTC's non-exhaustive list of factors still leaves considerable uncertainty about the subjective application of the marketing restriction.

What Entity Must Register as CPO of a RIC or Claim the Exclusion From Registration?

In the preamble to the Final Rules, the CFTC recognized the difficulty in requiring RICs themselves (or more specifically, the members of their boards) to register as CPOs, acknowledging that "requiring [registration of] a member or members of a RIC's board of directors would raise operational concerns for the RIC as it would result in piercing the limitation on liability for actions undertaken in the capacity of director."[25] Therefore, although the Final Rules are silent on this point, the CFTC explains in the preamble that if a RIC cannot claim the exclusion under Rule 4.5, then the RIC's adviser — not the RIC itself or members of the RIC's board — is required to register as the RIC's CPO.[26] Neither the preamble nor the Final Rules explain how, if at all, these registration requirements would impact a RIC's sub-adviser(s).

This recognition of the operational role of RIC advisers may lead the CFTC to break from past practice and allow RIC advisers to file the notice required to claim exclusion under Rule 4.5, even though the text of Rule 4.5(a) continues to grant the exclusion from the definition of CPO under new Rule 4.5 to the RIC itself and does not formally permit the RIC's adviser to file the notice of exclusion.

Are Controlled-Foreign Corporations Addressed?

Yes. The use of CFCs by some RICs for trading derivatives was a primary impetus for the CFTC's amendments to Rule 4.5.[27] It is therefore no surprise that the use of a CFC is one of the CFTC's factors for assessing a RIC's compliance with the marketing restriction. The use of a CFC also may impact whether a RIC satisfies the trading restriction in new Rule 4.5. In the preamble to the Final Rules, the CFTC said that it believes that RICs use CFCs "as a mechanism to invest up to 25 percent of the RIC's portfolio in derivatives," and because of this, the use of a CFC may indicate that the

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24 76 Fed. Reg. 7976, 7989 (Feb. 11, 2011).

25 Final Rules, pg. 29. There is no indication that the CFTC's position vis-a-vis directors would be applicable in any contexts other than a RIC.

26 *Id*.

27 *See* 76 Fed. Reg. 7976, 7983-84 (Feb. 11, 2011).

RIC is engaging in derivatives trading in excess of the trading threshold.[28] Thus, it appears that the CFTC views the use of CFCs as potentially relevant to whether a RIC satisfies the trading restriction.

The CFTC states that a CFC that is wholly owned by a RIC and used for trading commodity interests falls within the plain language of the statutory definition of "commodity pool" and the operator of such a CFC must now consider whether it will be required to be registered with and regulated by the CFTC as a CPO. The CFTC made clear that it would not exclude or exempt the CFC's operator from CPO registration by virtue of the fact that the RIC-parent is excluded from the definition of CPO under Rule 4.5.

What Is the Impact on Advisers to RICs?

Advisers that have relied upon the exemption under Rule 4.14(a)(8)(i)(A) with respect to RICs that presently are excluded under Rule 4.5 will need to find another basis for exemption from CTA registration if the RIC can no longer qualify for the new Rule 4.5 exclusion.[29] The Final Rules do not explain whether such advisers will be required to comply within 60 days after the publication of the Final Rules in the Federal Register or on the same timeline as CPOs that are currently relying on a Rule 4.5 exclusion.

What Are the Compliance Dates for New Rule 4.5?

The preamble to the Final Rules states that compliance with the amendments to Rule 4.5 for the purposes of registration will occur on the later of December 31, 2012 or 60 days after the adoption (not publication apparently) of rules to define the term "swap" and to impose margin requirements for swaps.[30] The release suggests that RICs' operators that are required to have registered as CPOs not be required to comply with the CPO recordkeeping, reporting and disclosure requirements until 60 days after the effectiveness of final rules implementing the CFTC's harmonization proposal (discussed below).[31] RICs that have claimed exclusion under old Rule 4.5 will not be grandfathered and will be required to come into compliance by these dates.

II. The Harmonization Proposal

Will the CFTC's Regulatory Requirements for CPOs of RICs Conflict With SEC and FINRA Regulatory Requirements?

Without other amendments, a number of the CFTC's regulatory requirements for CPOs of RICs that are not excluded under new Rule 4.5 will directly conflict with the SEC and the Financial Industry Regulatory Authority (FINRA) regulatory requirements that apply to RICs. After multiple comment periods on this issue, the CFTC has proposed to harmonize with SEC and FINRA requirements the disclosure, reporting and recordkeeping requirements for advisers that also are registered as CPOs with respect to a RIC.[32] Specific areas identified as needing harmonization include:

- the timing of delivery of disclosure documents to prospective investors;
- the signed acknowledgement requirement for receipt of disclosure documents;

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28 Final Rules, pg. 27-28.

29 For example, if an adviser is required to register as the CPO for a RIC, then it would be exempt from registering as the CTA for that same RIC under CFTC Rule 4.14(a)(4). 17 C.F.R. § 4.14(a)(4).

30 Final Rules, pg. 32.

31 Final Rules, pg. 33.

32 Harmonization of Compliance Obligations for Registered Investment Companies, 77 Fed. Reg. ___ (Feb. ___, 2012) (hereinafter the "Harmonization Proposal").

- the timing for updating disclosure documents;
- the timing of financial reporting to investors;
- the requirement that a CPO maintain its books and records on site;
- the required format for disclosing fees;
- the required disclosure of past performance of other funds;
- the inclusion of mandatory certification language; and
- the use of a summary prospectus for open-end RICs.

In response to the CFTC's original proposal to amend Rule 4.5, several commenters suggested that the CFTC consider extending the exemptive relief it had adopted for CPOs operating commodity-based exchange-traded funds (commodity ETFs) under Rule 4.12(c). The Harmonization Proposal adopts this suggestion and attempts to modify Rule 4.12(c) to address commenters' broader concerns in respect of RICs.

What Has Been Proposed for the Content and Timing of Disclosure Documents?

The CFTC states its belief that, as a general matter, CFTC-required disclosures can be presented concomitant with SEC-required information in a RIC's prospectus.[33] In an attempt to address certain potential conflicts, the CFTC has proposed:

- *Performance Presentation.* In certain circumstances CFTC rules require a CPO to present the performance of pools and accounts other than the commodity pool it is offering in the disclosure document — a requirement which conflicts with SEC disclosure requirements.[34] The CFTC proposes to require that any such performance of other pools and accounts be presented in the RIC's Statement of Additional Information. Recognizing that even this may conflict with SEC requirements, the CFTC notes that it has had preliminary discussions with the SEC staff on this issue.[35]
- *Cautionary Statement.* The CFTC proposes to combine its cautionary statement with that required by Rule 481(b)(1) under the Securities Act of 1933 (Securities Act).[36]
- *Break-Even Point and Fee/Expense Disclosure.* CFTC rules require commodity pools to disclose a "break-even point" intended to demonstrate to an investor the trading profit a pool must realize in the first year for the investor to recoup its initial investment.[37] The CFTC requires this disclosure to be included in the "forepart" of the

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33 Harmonization Proposal, pg. 8.

34 17 C.F.R. § 4.25(c)(2) – (5).

35 Harmonization Proposal, pg. 9. The CFTC also notes that the SEC staff stated that it would consider requests for no-action relief regarding the performance presentations, if necessary and appropriate. *Id*.

36 The legend could state either:

"The Securities and Exchange Commission and the Commodity Futures Trading Commission have not approved or disapproved these securities or this pool, or passed upon the adequacy or accuracy 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 this pool, or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense."

37 17 C.F.R. § 4.24(i)(6).

disclosure document and requires the disclosure of certain fees and expenses.[38] The CFTC finds the inclusion of the break-even point in a RIC's prospectus necessary because it mandates a greater level of detail regarding brokerage fees (presumably as compared to the method for calculating a RIC's expense ratio) and does not assume a specific rate of return.[39] The CFTC also proposes that any other fees and expenses required to be disclosed by CFTC rules that are not otherwise included in the fee table required in a RIC's prospectus would need to be disclosed along with the tabular presentation of the RIC's break-even point. The CFTC will consider the forepart of an open-end RIC's prospectus to be that part of the prospectus immediately following all disclosures required to be included in the summary prospectus.[40] For closed-end RICs, the CFTC did not identify any particular part of the prospectus that it would consider the forepart of the prospectus.

- *Timing of Updates.* The CFTC is proposing to require that disclosure documents be dated no more than 12 months prior to the date of their use, as opposed to the nine months currently required. The CFTC's stated intent is to be consistent with updating requirements under the federal securities laws.[41] Additional issues regarding the delivery and acknowledgement of disclosure documents and the period of time during which disclosure documents must be kept current are discussed below under "Are There Any Other RIC Issues?"

- *Filing of Amendments.* The CFTC is proposing to allow CPOs of "pools that provide for daily liquidity" to post on their internet websites amended disclosure documents at the same time such amendments are filed with the NFA. If allowed, this change in policy would resolve a timing issue that has troubled publicly offered commodity pools and commodity ETFs for several years. The Harmonization Proposal, however, does not address how conflicting comments from NFA and the SEC on the same disclosure document would be resolved.

What Has Been Proposed for the Timing and Certification of Periodic Reports?

CFTC rules require most CPOs to provide monthly periodic reports to investors; whereas, SEC rules require only that annual and semi-annual reports be provided to RIC investors.[42] Prior commenters have argued that RICs should not be required to provide monthly reports to investors and that the CFTC should accept the reporting regime established under the federal securities laws. In the Harmonization Proposal, the CFTC expressly declined to propose relief regarding the content or timing of monthly account statements required under its rules. According to the CFTC, the information required

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38 17 C.F.R. § 4.24(d)(5).

39 Harmonization Proposal, pg. 10.

40 *Id.*

41 The CFTC's stated intent of consistency with the requirements of the federal securities laws (i.e., Section 10(a)(3) of the Securities Act) will not always be realized because the language of CFTC Rule 4.26 is tied to the date of the disclosure document rather than the date of the information contained in such document. Accordingly, unless the CFTC modifies its proposed amendment to Rule 4.26 to track Section 10(a)(3) of the Securities Act, each open-end RIC would want to file its annual prospectus update under Securities Act Rule 485 as close as possible to the 120th day following its fiscal year end, taking into account the different time frames for automatic effectiveness under paragraphs (a) and (b) of Rule 485. Otherwise, if such open-end RIC files and becomes automatically effective earlier than the 120th day following its fiscal year end (Rule 8b-16 of the Investment Company Act requires that all annual updates be made within the 120-day period following the RIC's fiscal year end), such RIC will have shortened its time frame for preparing and filing its annual updates in all subsequent years.

42 17 C.F.R. § 4.22(b). The SEC also requires RICs to file various other periodic reports in addition to annual and semi-annual reports (*e.g.*, Form N-SAR, Form N-Q, Form N-PX); these reports, however, are not mailed to investors.

to prepare such account statements should be readily available to a RIC's investment adviser.[43] The CFTC is proposing, however, to permit RICs to satisfy the requirement to deliver account statements to investors by making such account statements available on their websites. In its proposed rule, the CFTC also would require a RIC's disclosure document to clearly indicate that such account statements will be readily accessible on its website and to provide the internet address of such website.

Notwithstanding the proposed relief from the delivery requirements for monthly account statements, the preparation of such account statements in conformity with the timing and content requirements of CFTC rules is likely to impose added burdens and costs on RICs and their investment advisers. Moreover, the requirement to prepare and publicize monthly account statements may require RICs that are engaged in a continuous public offering of their securities, such as open-end RICs and certain closed-end RICs, to expose themselves to additional liability under the federal securities laws since these monthly account statements might be viewed as "prospectuses" under Rule 482 of the Securities Act.[44]

CFTC rules also require CPOs to include in monthly account statements and annual reports a certification as to the accuracy and completeness of the information contained in such monthly account statements and annual reports.[45] The CFTC stated that it will accept the SEC's certification required of RICs on Form N-CSR as meeting the requirements of the CFTC's rules, as long as such certification is part of the Form N-CSR filed with the SEC.[46] No separate filing with the CFTC would be required.

Notably, the CFTC requires a certification not only on annual reports, but also on each monthly account statement. The CFTC's proposed rule states that a CPO may meet the CFTC's certification requirement by "including the certification required by Rule 30e-1 under the Investment Company Act of 1940 (17 CFR 270.30e-1) with its posting [on its website] of the pool's Account Statements." Rule 30e-1, however, does not contain any particular certification requirements, and presumably the CFTC means this to be a reference to the certification required on Form N-CSR. Moreover, any monthly account statements produced by RICs are not proposed to be filed with the SEC under the cover of Form N-CSR. Thus the CFTC presumably would be willing to accept this certification on monthly account statements without having it filed with the SEC under the cover of Form N-CSR, though the Harmonization Proposal does not expressly address this point.[47]

Are There Any Other RIC Issues?

The CFTC also is proposing to extend the relief currently available to commodity ETFs to RICs generally. The relief would permit RICs to satisfy the CFTC's disclosure document delivery and acknowledgement requirements by posting the disclosure document to the CPO's website.[48] The Harmonization Proposal does not address the period of time during which a CPO would have to keep a RIC's disclosure document current and posted to the CPO's website. Presumably, the CFTC will

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43 Harmonization Proposal, pg. 12.

44 To the extent monthly account statements might be viewed as "prospectuses" under Rule 482, they could be required to be filed with the SEC under Rule 497 of the Securities Act if not filed with FINRA as sales material.

45 17 C.F.R. §4.22(h).

46 Harmonization Proposal, pg. 13.

47 CFTC rules require these monthly account statements to include certain financial statements and Rule 30b2-1 under the Investment Company Act of 1940 (Investment Company Act) requires RICs to file with the SEC a copy of every periodic or interim report or similar communication to shareholders containing financial statements that is not otherwise required to be filed with the SEC (*e.g.*, as are a RIC's annual and semi-annual reports). Any such periodic or interim reports containing financial statements are not, however, required to be filed and certified on Form N-CSR; rather, they have their own submission type.

48 The relief also would permit a RIC's CPO to maintain its books and records with respect to the RIC at the RIC's administrator, distributor or custodian, or a bank or registered broker or dealer acting in a similar capacity, rather than at the CPO's main business office.

confirm in the final rulemaking that internet posting would only be required during the period of time during which the RIC is conducting a primary offering of its securities and would not apply if the only transactions in a RIC's shares were occurring on an exchange or other secondary market.

Also, the CFTC's new approach (discussed earlier) of requiring the RIC's adviser to register as the RIC's CPO if a RIC cannot claim the exclusion under Rule 4.5 could result in the RIC's adviser making the reports and disclosures with respect to the RIC-as-commodity-pool under CFTC Rules. Neither the Final Rules nor the Harmonization Proposal address any of the ancillary issues that may flow from this regulatory structure, particularly in respect of liability for the contents of such reports and disclosures.

What Is the Deadline for Comments on the Harmonization Proposal?

Comments on the Harmonization Proposal are due 60 days after the publication of the Harmonization Proposal in the Federal Register.

III. Private Funds and Their Advisers

How Do the Final Rules Impact Private Funds and Their Advisers?

The Final Rules repeal one of the private fund industry's most frequently relied-upon exemptions from CPO registration — Rule 4.13(a)(4) — but retain, with revisions, the exemption from CPO registration under Rule 4.13(a)(3). Since their introduction in 2003, these two exemption categories have been used by more than 10,000 different entities with respect to over 30,000 different funds.[49]

Rule 4.13(a)(4) has provided an exemption from CPO registration to operators of privately offered commodity pools whose participants satisfied certain investor sophistication requirements.[50] If an operator qualified for the exemption under Rule 4.13(a)(4), it only needed to file a notice with the NFA in order to be exempted from CPO registration (and from most CFTC and NFA regulations that attach to registered CPOs). For a pool whose operator was exempt under Rule 4.13(a)(4), there were no restrictions on trading commodity interests.

Rule 4.13(a)(3) was adopted at the same time as Rule 4.13(a)(4).[51] Rule 4.13(a)(3) provides an exemption from CPO registration to operators of privately offered commodity pools that only engage in a *de minimis* amount of commodity interest trading, that are not marketed as "vehicles for trading in the commodity futures or commodity options markets,"[52] and whose participants are SEC "accredited investors" or satisfy certain other sophistication requirements.[53] For some operators of and advisers to private funds, the retention of the exemption under Rule 4.13(a)(3) will ensure continued exemption from CFTC registration.

Trading Restriction Under Rule 4.13(a)(3)

Unlike the trading restriction in new Rule 4.5, Rule 4.13(a)(3) does not exclude *bona fide* hedging positions from the *de minimis* and net notional thresholds. Accordingly, in order to qualify for the

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49 76 Fed. Reg. 7976, 7986 (Feb. 11, 2011) (fn. 69).

50 Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors, 68 Fed. Reg. 47221 (Aug. 8, 2003).

51 *Id.*

52 17 C.F.R. § 4.13(a)(3)(iv).

53 17 C.F.R. § 4.13(a)(3)(iii).

exemption in Rule 4.13(a)(3), a private fund's use of futures or swaps[54] — whether used for *bona fide* hedging or not — must satisfy either of the following two measures:

- The aggregate initial margin, premiums and minimum security deposit required to establish the private fund's positions in futures, retail forex and swaps must not exceed 5 percent of the liquidation value of the private fund's entire portfolio (after taking into account the unrealized profits and unrealized losses on any such contracts);[55] or
- The aggregate net notional value of the private fund's positions in futures, retail forex and swaps must not exceed 100 percent of the liquidation value of the private fund's entire portfolio (after taking into account the unrealized profits and unrealized losses on any such contracts), determined at the time the most recent position was established.

The Final Rules specify that the aggregate net notional value for any cleared swap would be determined as consistent with Part 45 of the CFTC's regulations.[56] The Final Rules also state that a RIC may net swaps that are cleared on the same derivatives clearing organization, "where appropriate."[57]

Marketing Restriction Under Rule 4.13(a)(3)

The marketing restriction in Rule 4.13(a)(3) has existed since 2003 with the same operative language that the CFTC added to Rule 4.5 with respect to RICs ("…not marketed as … a vehicle for trading in the commodity futures or commodity options markets…"). The CFTC did not mention Rule 4.13(a)(3) in the preamble to the Final Rules when discussing the factors enumerated to determine compliance with the marketing test under new Rule 4.5. It is unclear whether those factors will bleed into the CFTC's analysis of whether a CPO satisfies the marketing test under Rule 4.13(a)(3).

Investor Sophistication Restriction Under Rule 4.13(a)(3)

The rescission of Rule 4.13(a)(4) may create issues in the application of the investor sophistication requirements in the Rule 4.13(a)(3) exemption. In order to qualify for the exemption under Rule 4.13(a)(3), the operator must believe that each participant in the fund (at the time of investment) is either:

- An "accredited investor," as defined in SEC Rule 501;[58]
- A trust that is not an accredited investor but that was formed by an accredited investor for the benefit of a family member;
- A "knowledgeable employee," as defined in SEC Rule 3c-5;[59]
- Certain other people directly or indirectly associated with the pool; or[60]
- Persons eligible to participate in Rule 4.13(a)(4) pools.

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54 Swaps are proposed to be added to the trading restriction in Rule 4.13(a)(3) through the proposal to amend Rule 4.10(a) to add a new definition for the term "commodity interest," which would include swaps. Amendments to Commodity Pool Operator and Commodity Trading Advisor Regulations Resulting From the Dodd-Frank Act, 76 Fed. Reg. 11701, 11703-11704 (March 3, 2011). The term "commodity interest" is used in Rule 4.13(a)(3)(ii). 17 C.F.R. § 4.13(a)(3)(ii).

55 As explained above, the swap margin requirements are still unknown. *See infra* n. 17.

56 *See infra* n. 19

57 *See infra* n. 21.

58 17 C.F.R. § 230.501.

59 17 C.F.R. § 270.3c-5.

60 These people are listed in CFTC Rule 4.7(a)(2)(viii)(A). 17 C.F.R. § 4.7(a)(2)(viii)(A).

As Rule 4.13(a)(4) will be rescinded at the same time that the revisions to Rule 4.13(a)(3) take effect, the CFTC's continued reference to persons eligible to participate in Rule 4.13(a)(4) pools as eligible participants in *de minimis* pools will have questionable meaning. As a result, it is unclear whether certain investors, such as non-United States persons, will be eligible to participate in a *de minimis* pool unless they can satisfy one of the other criteria.

Are Family Offices Exempt From Registration as CPOs and CTAs?

No, though family offices could be exempted in the future. While the Final Rules do not include a family office exemption, the preamble states that the CFTC "is directing staff to look into the possibility of adopting" such an exemption.[61] In the Harmonization Proposal, the CFTC has invited persons to comment on whether it should adopt an exemption similar to the family office exclusion recently adopted by the SEC.[62]

As the CFTC staff considers the feasibility of a family office exemption, family offices will continue to be permitted to seek interpretative relief and to rely on existing staff interpretative relief.[63] Any family offices that are required to register as CPOs or CTAs would be subject to all of the requirements attendant registration, including reporting on Forms CPO-PQR and CTA-PR.[64]

What Are the Compliance Dates for the Rescission of 4.13(a)(4)?

Operators of private funds that "are currently claiming" the exemption under Rule 4.13(a)(4) are not required to register or claim another exemption until December 31, 2012.[65] For operators of private funds that are not "currently" claiming the exemption under Rule 4.13(a)(4), the CFTC release suggests that Rule 4.13(a)(4) may no longer be available 60 days following publication of the Final Rules in the Federal Register. Note, however, that until the CFTC finalizes its rules further defining the term "swap" and until other exemptive relief expires, only private funds using futures or commodity options are commodity pools.

What Is the Impact on Advisers to Private Funds?

Rule 4.14(a)(8)(i)(D) has been amended to remove the exemption available to advisers that provide commodity interest trading advice to pools whose operators qualify for exemption from CPO registration under Rule 4.13(a)(4). The Final Rules retain the exemption under Rule 4.14(a)(8)(i)(D) to advisers of private funds whose operators qualify for the exemption under Rule 4.13(a)(3).

Advisers that have relied upon the exemption under Rule 4.14(a)(8)(i)(D) with respect to exempt pools also appear to be required to come into compliance with the amended exemption by December 31, 2012.

Are Foreign Advisers Exempt From Registration as CTAs?

No, the Final Rules do not include an exemption for foreign advisers. The preamble states that the CFTC is withholding consideration of a foreign adviser exemption until it can receive more information through Forms CPO-PQR and CTA-PR, as applicable.[66]

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61 Final Rules, pg. 44.

62 Harmonization Proposal, pg. 13. Comments will be accepted for 60 days following the publication of the Harmonization Proposal in the Federal Register.

63 *Id*.

64 Final Rules, pg. 55.

65 Final Rules, pg. 50. The CFTC does not explain whether "currently" means as of the date of adoption, the date of publication in the Federal Register or the date of the effectiveness of the repeal (60 days after publication in the Federal Register).

66 Final Rules, pg. 45.

IV. CFTC Registration and NFA Membership

What Will Registration Mean for Entities That Currently Are or Will Soon Become CPOs or CTAs?

Registration with the CFTC requires the completion of application forms for the entity, every "associated person" (unless such persons are exempt from registration) and certain principals of the entity, submission of fingerprint cards (for FBI background checks) and, depending on the type of entity, proficiency exams for its associated persons. Registered CPOs and CTAs also must comply with periodic disclosure requirements and the CFTC's recordkeeping requirements. As discussed in Section II above, registered CPOs must submit monthly or quarterly financial reports to investors and certified annual financial reports to the CFTC and NFA. Finally, registered CPOs now will be required to file either a Form CPO-PQR or Form PF and registered CTAs now will be required to file a Form CTA-PR or Form PF.[67]

In addition to CFTC registration, registered CPOs and CTAs are also required to become members of the NFA and comply with all NFA rules and bylaws. The NFA's rules and bylaws prescribe certain compliance requirements (such as employee supervision and business continuity planning) and create potential liability (through rules that require members to "observe high standards of commercial honor and just and equitable principles of trade …").[68] All members of the NFA are subject to periodic examinations and audits.

For many operators of and advisers to privately offered funds that will be required to register as CPOs or CTAs, the impact of registration will be mitigated by the availability of a partial registration exemption under CFTC Rule 4.7.[69] Rule 4.7 exempts the operators of privately offered funds whose shares are sold solely to "qualified eligible persons" (QEPs) from certain disclosure, reporting and recordkeeping requirements that are attendant CPO registration.[70] Similarly, Rule 4.7 exempts advisers to the accounts of QEPs from certain disclosure and recordkeeping requirements attendant CTA registration.[71] However, all registered CPOs and CTAs, even if partially exempted under Rule 4.7, will now be required to file the CFTC's new systemic risk reporting forms, Form CPO-PQR and CTA-PR.[72]

V. Form CPO-PQR and Form CTA-PR Filing Requirements

Who Is Required to File Forms CPO-PQR and CTA-PR?

The Final Rules require any registered CPO, including the registered CPO of a RIC, to file a Form CPO-PQR and any registered CTA, including the registered CTA of a RIC, to file a Form CTA-PR.[73] If a registered CPO or CTA is also a private fund adviser required to file Form PF, the Final Rules require such entities to file Form PF with the SEC in lieu of filing Forms CPO-PQR or CTA-PR.[74]

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67 Final Rules, pg. 129.

68 NFA Compliance Rule 2-4: Just and Equitable Principles of Trade.

69 CFTC Rule 4.7 provides partial exemptions from the disclosure, reporting and recordkeeping requirements for certain CPOs and CTAs. 17 C.F.R. § 4.7. *See* n. 12.

70 17 C.F.R. § 4.7(b). QEPs are defined in Rule 4.7(a) and include, among other categories of investors, "qualified purchasers" and "knowledgeable employees" as defined in the Investment Company Act. 17 C.F.R. § 4.7(a)(2)(vi) and (vii).

71 17 C.F.R. § 4.7(c).

72 Final Rules, pg. 129.

73 Final Rules, pg. 129. The instructions to Schedules A, B and C of Form CPO-PQR direct a reporting CPO to answer with respect to the pools that the CPO operated during the reporting period. It is not clear whether this instruction is limited only to the pools for which the CPO has not claimed an exclusion or exemption or whether it includes all pools irrespective of whether the CPO has claimed exclusion or an exemption with respect to such pools.

74 Final Rules, pg. 129-130.

Registered CPOs that have at least $5 billion in assets under management attributable to commodity pools will be required to file their first Form CPO-PQR within 60 days after September 30, 2012, and quarterly thereafter. All other registered CPOs and CTAs will be required to file Form CPO-PQR and CTA-PR within 90 days of the close of each calendar year. However, any operators or advisers that are required to register as CPOs or CTAs as a result of the Final Rules would not be required to file either Form CPO-PQR or Form CTA-PR until they are actually registered with the CFTC.

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