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CFTC Changes Rules Affecting Public and Private Funds

Introduction

The Commodity Futures Trading Commission (CFTC) on February 9, 2012 adopted final rules under the Commodity Exchange Act as amended (CEA) that modify and eliminate certain CFTC registration exclusions and exemptions widely used by sponsors of investment companies registered under the Investment Company Act of 1940 as amended (1940 Act) (mutual funds) and private investment funds.[1] These rule changes will result in significant changes to the manner in which both public and private funds using commodity futures, commodity options and many derivatives will be offered, operated, and regulated, as well as result in significant costs to those funds and their advisers. Every public and private adviser will need to evaluate its business and operational and compliance infrastructures in light of these changes.

In summary, the final rules:

- reinstate and expand the trading and marketing criteria necessary for advisers to mutual funds to qualify under CFTC Regulation 4.5 for an exclusion from the definition of commodity pool operator (CPO);
- rescind the exemption under CFTC Regulation 4.13(a)(4) from CFTC registration for CPOs to commodity pools privately offered solely to qualifying investors;
- modify the criteria for claiming the exemption under CFTC Regulation 4.13(a)(3) from CFTC registration for CPOs to commodity pools with very limited use of commodity interests, but otherwise retain Regulation 4.13(a)(3);
- require all persons that claim exclusionary or exemptive relief under CFTC Regulations 4.5, 4.13, and 4.14 from CPO or commodity trading advisor (CTA) registration (respectively) to re-confirm their qualifications annually on a calendar-year basis, commencing with the calendar year ending December 31, 2012;
- modify the reporting requirements and participant qualification criteria for CPOs and CTAs relying on CFTC Regulation 4.7;
- require CPOs and CTAs that are registered with the CFTC to file certain new reports on Form CPO-PQR and Form CTA-PR (respectively) regarding their commodity trading activities;[2] and
- amend the standardized risk disclosure required to be included in CPO and CTA disclosure documents to describe certain risks of swap transactions.

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1 Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11252 (Feb. 24, 2012) (to be codified at 17 C.F.R. §§ 4, 145 and 147) (Adopting Release).

2 This reporting will be in addition to any applicable periodic reporting to clients.

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In addition, the CFTC proposed certain harmonization provisions in order to facilitate compliance by mutual funds with the CFTC's disclosure, reporting, and recordkeeping provisions by attempting to align the CFTC's requirements with those placed on mutual funds by the Securities and Exchange Commission (SEC).

Dechert LLP, on behalf of itself and many affected clients, commented extensively on these regulations as proposed.[3] Additionally, Dechert published multiple client alerts on this regulatory initiative.[4]

CFTC Regulation 4.5

CFTC Regulation 4.5 currently excludes a mutual fund and its operator and other entities from the definition of a CPO. The amendments reinstate and expand pre-2003 regulations for purposes of determining whether a mutual fund may rely upon the exclusion. Specifically, the amendments condition a mutual fund's reliance upon the Regulation 4.5 exclusion on certain trading thresholds and marketing restrictions (as discussed below). An adviser to a mutual fund unable to meet these limitations will be required to register as a CPO and submit to regulation by the CFTC and the National Futures Association (NFA).

New Conditions

Under the final rules, to rely on the exclusion in Regulation 4.5, a mutual fund must represent that:

- with respect to exchange-traded commodity futures, options on such futures, and commodity options and over-the-counter (OTC) swaps (commodity interests) used for purposes <u>other than</u> solely *bona fide* hedging purposes (as determined under CFTC Regulations 1.3(z)(1) and 151.5),[5] either:
    - the aggregate initial margin and premiums required to establish the mutual fund's positions in such instruments will not exceed 5% of the liquidation value of the mutual fund's portfolio (after accounting for unrealized profits and unrealized losses on such instruments)[6] (5% Trading Test); <u>or</u>
    - the aggregate net notional value of such instruments, determined at the time of the most recent position established, does not exceed 100% of the liquidation value of the mutual fund's portfolio (after accounting for unrealized profits and unrealized losses on such instruments) (Net Notional Test);[7]

<u>and</u>

- the mutual fund will not be, and has not been, marketing participations in the mutual fund to the public as a "commodity pool"[8] or otherwise

3 Over the course of the rulemaking process, Dechert submitted four comment letters to the CFTC and advised on several others, addressing various aspects of the proposals. The Dechert comment letters are available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26313&SearchText= (addressing the Notice of Petition for Rulemaking), http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42176&SearchText= (addressing the proposed Part 4 rule changes that would affect private investment funds and their advisers), http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42183&SearchText= (addressing the proposed Part 4 rule changes that would affect mutual funds and their service providers), http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47953&SearchText= (Dechert July 2011 Comment Letter) (addressing additional issues related to the Part 4 rule changes).

4 NFA Petitions for Rulemaking to Amend Regulation Excluding Registered Investment Companies from CFTC Regulation, *DechertOnPoint* (August 2010) *available at* http://www.dechert.com/NFA_Petitions_for_Rulemaking_to_Amend_Regulation_Excluding_Registered_Investment_Companies_from_CFTC_Regulation_08-27-2010/, Proposal to Rescind CFTC Registration Exemptions Will Affect Many Public and Private Investment Funds, *DechertOnPoint* (February 2011) *available at* http://www.dechert.com/Proposal_to_Rescind_CFTC_Registration_Exemptions_Will_Affect_Many_Public_and_Private_Investment_Funds_02-11-2011/.

5 17 C.F.R. §§ 1.3(z); 151.5.

6 In the case of an option that is in-the-money at the time of purchase, the in-the-money amount, as defined in CFTC Regulation 190.01(x), may be excluded in computing such 5%. 17 C.F.R. § 4.5(c)(2)(iii)(A).

7 17 C.F.R. § 4.5(c)(2)(iii)(B).

8 The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amended the CEA to define commodity pool as "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any . . . commodity for future delivery, securities futures product, or swap." 7 U.S.C. § 1a(10). The term "pool" is defined in the CFTC regulations as "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests." 17 C.F.R. § 4.10(d).

as a vehicle for trading in commodity interests (Marketing Restriction).[9]

The discussion below describes the amendments originally proposed by the CFTC on January 26, 2011,[10] comments received on the proposal and highlighted in the Adopting Release, and how the amendments that were adopted differed from the proposal.

Overview of Proposed Amendments

In August 2010, the NFA petitioned the CFTC to amend Regulation 4.5.[11] The NFA requested that the CFTC place limitations on the then-existing blanket exclusion for mutual funds under Regulation 4.5, thereby requiring mutual funds with greater than *de minimis* investments in commodity interests to register and be regulated as CPOs. Limitations similar to those proposed by the NFA were in place prior to 2003.

Under Regulation 4.5 as in effect prior to 2003, a mutual fund could qualify for the CPO exclusion only if its commodity interest trading was (i) conducted solely for *bona fide* hedging purposes as defined by Regulation 1.3(z)(1),[12] or (ii) if not conducted for *bona fide* hedging purposes, the aggregate initial margin and premiums for those positions could not exceed 5% of the liquidation value of the mutual fund's portfolio after taking into account unrealized profits and unrealized losses on such positions (Pre-2003 5% Trading Test).[13] In addition, the mutual fund could not be marketed as a commodity pool or vehicle for trading in commodity interests (Pre-2003 Marketing Restriction), but this restriction did not extend to trading in swaps or other OTC instruments providing indirect exposure to the commodity markets.

In 2003, the Pre-2003 5% Trading Test and the Pre-2003 Marketing Restriction were removed. The CFTC's rationale in doing so was "to encourage and facilitate participation in the commodity interest markets by additional collective investment vehicles and their advisers, with the added benefit to all market participants of increased liquidity."[14] Those desired goals have been achieved with significant benefits to the markets and investors. Moreover, the investor demand for asset diversification and commodity exposure has resulted in substantial growth of mutual funds utilizing derivatives. Accordingly, prior to the recently-announced amendments, Regulation 4.5 had not limited the amount of commodity interest trading a mutual fund could conduct in order to qualify for the CPO exclusion.[15]

Comments and Rules Adopted

The CFTC received numerous comments on its proposed amendments to Regulation 4.5, including: the 5% Trading Test; the Marketing Restriction; the appropriate person to register as a CPO; the use of mutual fund subsidiaries in the form of "controlled foreign corporations" (CFCs); and regulatory harmonization and implementation issues.

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9 17 C.F.R. § 4.5(c)(2)(iii)(C).

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

11 Letter from Thomas W. Sexton, III, Senior Vice President and General Counsel, NFA, to David Stawick, Office of the Secretariat, CFTC (Aug. 18, 2010) (NFA Letter), *available at* http://www.nfa.futures.org/news/newsPetition.asp?ArticleID=3630.

12 17 C.F.R. § 1.3(z)(1). Since adopting Regulation 1.3(z)(1) in 1977, the CFTC has clarified, interpreted, and reinterpreted what it means to be engaged in *bona fide* hedging. *See* Background on Position Limits and the Hedge Exemption, Statement of Dan M. Berkovitz, General Counsel, CFTC (Jan. 14, 2010), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/proposedrule011410_berkovitz.

On October 18, 2011, the CFTC adopted a comprehensive set of rules addressing the incorporation of OTC derivatives into the CFTC's existing position limit regime for exchange-traded futures and options (Position Limit Rules). In adopting the Position Limit Rules, the CFTC made changes to what qualifies as "*bona fide* hedging transactions and positions" as defined in Regulation 1.3(z)(1). The CFTC has incorporated the new definition of *bona fide* hedging in Regulation 151.5 into Regulation 4.5. For a discussion of the position limit rulemaking, refer to CFTC Finalizes Futures and Swaps Position Limit Rules, *DechertOnPoint* (Nov. 2011) *available at* http://www.dechert.com/CFTC_Finalizes_Futures_and_Swaps_Position_Limit_Rules_11-15-2011/.

13 Any in-the-money amount on commodity options was excluded from the 5% calculation.

14 Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues, 68 Fed. Reg. 47221, 47223 (Aug. 8, 2003) (2003 Release).

15 However, a mutual fund's investment in commodities has been, and is still, limited by Subchapter M of the Internal Revenue Code of 1986 as amended and provisions of the 1940 Act.

5% Trading Test and Alternative Net Notional Test

With respect to the proposed trading threshold, the CFTC received comments seeking certain exclusions and proposing alternatives. The CFTC rejected commenters' requests for exclusion from the threshold calculation for various broad-based stock index futures (*e.g.*, futures on the S&P 500 Index), security futures generally, and financial futures contracts as a whole. The CFTC also rejected requests for an expansion of the definition of *bona fide* hedging to include risk management for purposes of Regulation 4.5, stating that the CFTC believes there is an important distinction between *bona fide* hedging transactions and risk management transactions. According to the CFTC, *bona fide* hedging transactions are unlikely to present the same level of market risk as risk management transactions because *bona fide* hedging transactions are offset by exposure in the physical markets. Further, the CFTC expressed concern that excluding risk management transactions from the trading threshold calculation would permit mutual funds to engage in a greater volume of derivatives trading than other entities that engage in the same activities but are required to register as CPOs.[16]

Among other alternatives suggested, in a July 2011 comment letter on the proposals, Dechert proposed that the CFTC consider adopting an alternative to the 5% Trading Test that would be similar to the "aggregate net notional value test" currently available to CPOs claiming an exemption from registration as CPOs under CFTC Regulation 4.13(a)(3)(ii)(B).[17] In response, the CFTC adopted this alternative test, stating that it "no longer believes that its prior justification for abandoning the alternative net notional test is persuasive."[18] The CFTC further stated that it "believes that the adoption of an alternative net notional test will provide consistent standards for relief from registration as a CPO for entities whose portfolios only contain a limited amount of derivatives positions and will afford [mutual funds] with additional flexibility in determining eligibility for exclusion."[19]

Marketing Restriction

The CFTC agreed with commenters that the proposed inclusion of the clause "or otherwise seeking investment exposure to" in the Marketing Restriction would introduce an unacceptable level of ambiguity into the restriction, and accordingly removed this clause from the final rule. However, the final Marketing Restriction remains broad and invites a second-guessing of mutual fund sponsors' conclusions as to whether their funds meet the test.

To address comments seeking guidance on what factors the CFTC would consider in determining whether a mutual fund triggered the Marketing Restriction, the CFTC provided the following list of factors it considers indicative of marketing a mutual fund as a vehicle for investing in commodity interests:

- the name of the fund;
- whether the fund's primary investment objective is tied to a commodity index;
- whether the fund makes use of a CFC for its derivatives trading;
- whether the fund's marketing materials, including its prospectus or disclosure document, refer to the benefits of the use of derivatives in a portfolio or make comparisons to a derivatives index;
- whether, during the course of its normal trading activities, the fund has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives;

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16 It is unclear what effect the CFTC's position regarding what strategies will qualify as *bona fide* hedging set forth in the Adopting Release will have on its previous interpretive guidance on what qualifies as *bona fide* hedging for Regulation 4.5 purposes. *See, e.g.*, CFTC Interpretive Letter No. 90-13 (July 9, 1990).

17 Dechert July 2011 Comment Letter at 15 ("Consideration should also be given to making available an alternate test such as an aggregate net notional value test similar to the one available to private commodity pools in current Regulation 4.13(a)(3)(ii)(B). As the net notional value test is a legitimate test the CFTC currently uses to determine when it should require CPO registration based on the amount of commodity interest trading, there is no reason not to use it in the [mutual fund] context as well.").

18 The CFTC had considered this alternative test prior to its 2003 Regulation 4.5 amendments. When the CFTC removed the Pre-2003 5% Trading Test and Pre-2003 Marketing Test from Regulation 4.5, it saw no purpose in instituting this alternative test. Although modeled on Regulation 4.13(a)(3)(ii)(B), the Net Notional Test is broader in that it allows unlimited use of futures, options, or swaps for *bona fide* hedging purposes, which is not permitted under Regulation 4.13(a)(3).

19 Adopting Release at 11258.

- whether the futures/options/swaps transactions engaged in by the fund or on behalf of the fund will directly or indirectly be its primary source of potential gains and losses; and
- whether the fund is explicitly offering a managed futures strategy.

The CFTC noted that it would "give more weight" to the last factor in determining whether a mutual fund is operating as a *de facto* commodity pool.

Other Comments

Many commenters asserted that a mutual fund's investment adviser is the appropriate person to register in the capacity of the mutual fund's CPO, and the CFTC agreed. The CFTC also agreed with commenters that members of a mutual fund's board of directors/trustees would not be expected to register individually as CPOs. [20]

The NFA Letter had expressed concern regarding the use by commodity-based mutual funds of "a subsidiary [such as a CFC] for tax and mutual fund regulatory purposes." [21] In its petition to the CFTC, the NFA stated that these subsidiaries are not themselves subject to the 1940 Act, although in fact they are subject to certain investment restrictions applicable to their parent funds and certain conditions the Internal Revenue Service has mandated for their use. Many commenters requested that the CFTC continue to permit mutual funds to use CFCs and either to allow such CFCs to be exempt from registration with the CFTC under Regulation 4.13 or to exclude such CFCs under Regulation 4.5 by reason of their sole investor also being excluded. The CFTC responded by indicating that it does not oppose the continued use of CFCs by mutual funds, but it believes that CFCs falling within the statutory definition of commodity pool should be subject to regulation as a pool. Further, the CFTC stated that a CFC should not be excluded simply because its parent company is a mutual fund that may be excluded under Regulation 4.5. The CFTC's amendments include rescinding the CPO exemption from registration that many operators of CFCs qualify for and rely upon under Regulation 4.13(a)(4) (as discussed below).

The CFTC agreed with commenters that it is necessary to harmonize the compliance obligations it places on mutual funds under the CFTC's Part 4 Regulations with the SEC's regime, and concurrently proposed certain modifications to the Part 4 Regulations to achieve that goal (as discussed below).

Compliance Deadline

Advisers previously relying on the Regulation 4.5 CPO exclusion that are no longer eligible to do so will be required to register with the CFTC by the later of (i) December 31, 2012 or (ii) 60 days following the final rules (yet to be adopted by the CFTC and SEC) defining the term "swap" and establishing margin requirements for swap positions. Notwithstanding such CPO registration, such advisers will not be required to comply with the full CPO regulatory regime until 60 days following the effectiveness of the final CFTC and SEC harmonized disclosure, reporting, and recordkeeping rules (as discussed below).

The CFTC does not believe that it is appropriate to exclude those mutual funds that have already claimed relief under the current Regulation 4.5 exclusion, and declined to adopt any grandfathering relief.

Annual Notice Filing Requirement

The CFTC amended the notice provision of Regulation 4.5 to require that each mutual fund that has filed, or will file, a notice of exclusion under Regulation 4.5 must (i) affirm on an annual basis the notice of exclusion from registration, (ii) withdraw such exclusion due to the cessation of activities requiring registration or exclusion, or (iii) withdraw such exclusion and apply for registration within 30 days of the calendar year-end (in each case, commencing year-end December 31, 2012) through the NFA's electronic exclusion filing system.

CFTC Regulation 4.7

The CFTC modified certain provisions of CFTC Regulation 4.7, which provides a partial exemption from some of the disclosure, reporting, and recordkeeping requirements that would otherwise apply to registered CPOs and CTAs making commodity pool offerings, or providing commodity interest trading advice, to

[20] The CFTC needs to formally adopt the same position for directors and trustees of domestic and foreign corporations, trusts, and other entities that are not mutual funds but instead are subject to CPO registration or qualify for an exemption.

[21] NFA Letter.

"qualified eligible persons" (QEPs).[22] Most advisers to mutual funds currently relying on the CFTC Regulation 4.5 CPO exclusion will not be eligible for relief under Regulation 4.7. The CFTC proposed to require a registered CPO that operates pools in reliance on an exemption under Regulation 4.7 (an exempt pool) to include financial statements certified by an independent public accountant in its annual reports to pool participants. The CFTC had noted that, in 2009, 85% of pools that operated under the Regulation 4.7 exemption filed certified annual reports with the NFA notwithstanding the availability of the exemption.[23] The CFTC adopted its certification requirement as proposed, but will entertain individual requests for relief for exempt pools with limited numbers of qualified participants. The CFTC might provide no-action relief to an exempt pool whose participants are, for example, the principals, specific employees, and related persons of the CPO/CTA.

The CFTC also modified the criteria for participant qualification in a Regulation 4.7 exempt pool to reflect the SEC's "accredited investor" standard as it may change from time to time.[24]

As a result of these changes, a CPO to an exempt pool will need to arrange for an annual independent audit of the exempt pool's financial statements if it does not already do so. CPOs relying on Regulation 4.7 will also need to ensure that the interests in such exempt pools are offered and sold solely to QEPs that satisfy the new definition. Likewise, CTAs relying on Regulation 4.7 will need to ensure that commodity interest trading advice is given to similarly situated QEPs.

CFTC Regulations 4.13(a)(3) and 4.13(a)(4)

The CFTC rescinded the registration exemption for an operator of a commodity pool offered exclusively to certain categories of QEPs and accredited investors contained in CFTC Regulation 4.13(a)(4).[25] However, the final rules retain CFTC Regulation 4.13(a)(3), which provides a registration exemption for operators of pools that have very limited use of commodity interests and are only offered to accredited investors, knowledgeable employees, and certain categories of QEPs.[26]

The CFTC initially proposed the rescission of both Regulation 4.13(a)(3) and Regulation 4.13(a)(4). The CFTC noted that the current exemptions, which were adopted in 2003, have permitted a large group of market participants to fall outside the oversight of regulators, and stated that the benefits of "continuing to grant an exemption from registration and reporting obligations for these market participants is outweighed by the [CFTC's] concerns of regulatory arbitrage."[27] The 2011 Proposing Release also stated that eliminating the exemptions under Regulations 4.13(a)(3) and (a)(4) would be analogous to the Dodd-Frank Act mandate that the SEC require advisers to certain private funds to register with the SEC as investment advisers, and is in line with one of the primary purposes of the Dodd-Frank Act —"to promote transparency with respect to the activities of the financial markets." However, it must be noted that none of the actions taken in this CFTC rulemaking were addressed in, or mandated by, the Dodd-Frank Act or resulted from market, participant, or investor abuse; instead, they appear to have been prompted by the NFA and certain of its constituent members.

22 Regulation 4.7 relief for CPOs includes: (1) no requirement to deliver a disclosure document to commodity pool investors or to file a disclosure document with the NFA, but does include a requirement to disclose that the CPO is relying on Regulation 4.7; (2) quarterly reporting to pool investors, which would otherwise be monthly; and (3) relaxed requirements regarding the type of records that must be kept. Regulation 4.7 relief for CTAs includes: (1) no requirement to deliver a disclosure document to separately managed account holders or to file a disclosure document with the NFA, but does include a requirement to disclose that the CTA is relying on Regulation 4.7; and (2) relaxed requirements regarding the type of records that must be kept.

23 According to the CFTC, for fiscal year 2010, 91% of annual reports filed for exempt pools contained certified financial statements.

24 Previously, Regulation 4.7 defined QEPs to include (among others) persons who satisfy specific net worth and annual income criteria that are the same as those specified in the SEC's Regulation D accredited investor definition. The Dodd-Frank Act mandated that the SEC change the accredited investor definition to increase significantly the applicable thresholds. In anticipation of these changes, the CFTC has determined to incorporate the new standard by reference to Regulation D to maintain consistency between the regulatory provisions without subsequent conforming amendments.

25 QEPs are defined in Regulation 4.7, and include (among others) "Non-United States persons" as defined therein as well as "qualified purchasers" under the 1940 Act. The accredited investor standard is derived from the SEC's Regulation D. 17 C.F.R. § 4.13(a)(4).

26 17 C.F.R. § 4.13(a)(3).

27 2011 Proposing Release at 7985.

Retaining Regulation 4.13(a)(3)

After reviewing comments that urged the CFTC to maintain a *de minimis* exemption, the CFTC determined that overseeing entities that qualify for Regulation 4.13(a)(3), which have minimal exposure to commodity interests, would not be the best use of the CFTC's limited resources. The CFTC thus retained the Regulation 4.13(a)(3) CPO registration exemption without increasing the trading threshold as had been requested, but with some modifications, including incorporating the initial margin used for swaps into the *de minimis* calculation. The CFTC maintained the Regulation 4.13(a)(3) exemption to provide for consistent treatment of entities with limited commodity interest exposure under CFTC Regulation 4.5. Under the new rules, the measures of *de minimis* exposure are the same under Regulation 4.13(a)(3) and Regulation 4.5, except, importantly, that Regulation 4.5 permits unlimited commodity interest trading for *bona fide* hedging purposes while Regulation 4.13(a)(3) does not.

Faced with the rescission of Regulation 4.13(a)(3), some commenters had suggested that the CFTC create a CPO registration exemption for investment advisers that are registered with the SEC and are not primarily engaged in trading commodity interests. Such an exemption would have mirrored a similar exemption available to CTAs in Section 4m(3) of the CEA. The CFTC declined to create such a CPO exemption, rejecting the assertion that this statutory CTA exemption demonstrated Congressional intent to avoid dual registration with the SEC and CFTC.

Rescission of Regulation 4.13(a)(4)

The CFTC determined that an increased level of regulation by way of rescinding the exemption under CFTC Regulation 4.13(a)(4) is appropriate with respect to entities participating in the commodity interest markets. In the 2011 Proposing Release, the CFTC stated that the intent behind the rescission of CFTC Regulation 4.13(a)(4) was to hold commodity pools that previously qualified for the exemption to the same transparency and accountability standards that are applied to publicly offered commodity pools whose interests are registered securities with the SEC under the Securities Act of 1933 as amended (Securities Act). The CFTC believes "that it is appropriate to limit regulatory arbitrage" by harmonizing the data it collects with respect to pools that are situated similarly to private funds, so that operators of such pools "will not be able to avoid oversight by either the [CFTC] or the SEC." [28]

Under this same reasoning, the CFTC did not include any grandfathering relief for CPOs that previously were exempt from registration under Regulation 4.13(a)(4). The rescission of the regulation will become effective April 24, 2012. CPOs may continue relying on the exemption for their existing private commodity pools until December 31, 2012, at which time they must be registered and in compliance with applicable regulations. However, the CFTC expects CPOs to commodity pools formed and commencing business on or after the effective date of the final rules to register as CPOs and comply with the CFTC's regulations concurrently upon their pools' formation and commencement of operations, or alternatively qualify for another CPO compliance exemption or exclusion.

Comments on Rescission of Regulation 4.13(a)(4)

Many of the comments in response to the proposed rescission of Regulation 4.13(a)(4) requested a new registration exemption for certain subsets of CPOs that had previously relied on Regulation 4.13(a)(4). Commenters requested exemptions from CPO registration for:

- family offices;
- foreign advisors;
- funds that only invest in commodity interests through a fund-of-funds structure (as discussed below); and
- pools that may not be able to take advantage of CFTC Regulation 4.7 due to the rescission of Regulation 4.13(a)(4).

The CFTC considered each request, but in all cases declined to create a new exemption at this time. The CFTC stated that, before creating other exemptions, it must first gather information on the various categories of CPOs through the new CFTC Form CPO-PQR (and other required reporting by registered CPOs, such as the new SEC Form PF) to develop a comprehensive view of the industry. While the CFTC may consider limited registration exemptions in the future, it noted that family offices and funds-of-funds may currently seek exemptive relief on a case-by-case basis. Although not

28 Adopting Release at 11264.

explicitly stated, it appears that registered CPOs that operate offshore commodity pools may continue to rely on prior advisory guidance providing relief from certain disclosure, reporting, and recordkeeping requirements.[29]

Implications of Rescission of Regulation 4.13(a)(4)

Many sponsors and advisers to commodity pools that would otherwise be required to register with the CFTC as CPOs and/or CTAs currently rely on the exemption from registration under Regulation 4.13(a)(4) and the corollary exemptions from registration as CTAs under CFTC Regulations 4.14(a)(5) and (a)(8), among other CTA exemptions.[30] In addition, the CFCs that mutual funds use for commodity interest investing are part of this group of market participants.

Unless a CPO can rely on another exemption to the CPO registration requirement (*e.g.*, Regulation 4.13(a)(3) as discussed above, or CFTC Regulation 30.4 for certain operators of non-U.S. commodity pools), the rescission of Regulation 4.13(a)(4) means that sponsors of such private pools will be required to register with the CFTC and become subject to the disclosure, reporting, recordkeeping, advertising, and compliance requirements imposed under the CFTC's regulatory scheme.[31] CPOs currently relying on the CPO registration exemption in Regulation 4.13(a)(4) that are, or can become, eligible to rely on the exemption in Regulation 4.13(a)(3) may make the change whenever they satisfy the criteria of Regulation 4.13(a)(3). Many of the previously exempt CPOs will also be required to report on the private funds they advise on the new SEC Form PF filed with the SEC, among the other requirements.[32] In addition, many advisers relying on the CTA exemption from registration based on their status under Regulation 4.14(a)(4) will need to register as a CTA because the corresponding CPO of the pool that it is advising will no longer be exempt from registration. However, most sponsors and advisers to commodity pools currently relying on the CPO registration exemption in Regulation 4.13(a)(4) will be able to claim exemptions available to registered CPOs and CTAs under Regulation 4.7 with respect to certain disclosure, reporting, and recordkeeping requirements (as discussed herein). Additionally, CFTC Regulation 4.12 provides exemptions to registered CPOs from certain disclosure, reporting, and recordkeeping requirements. This exemption is limited to CPOs of commodity pools whose interests are offered publicly under the Securities Act or privately pursuant to an exemption thereunder, which generally and routinely engage in the trading of securities, which trade commodity interests in a manner solely incidental to their securities trading activities, and which limit the aggregate initial margin and premiums required to establish commodity interest contracts to 10% or less of the market value of the pool's assets (after accounting for unrealized profits and unrealized losses on such contracts).[33]

CFTC Regulation 4.27; Reporting Forms for CTAs and CPOs

The CFTC adopted new CFTC Regulation 4.27 as proposed, requiring all registered CTAs and CPOs to file CFTC Forms CTA-PR and CPO-PQR (respectively) to allow the CFTC to provide systemic risk information to the FSOC and other regulators and conduct its own oversight role. The CFTC adopted the new Form CTA-PR and Form CPO-PQR with certain changes to the substance of the forms and the filing timelines. In proposing the new rule and forms, the CFTC cited a

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29 CFTC Advisory No. 18-96, Comm. Fut. L. Rep. (CCH) ¶ 26,659 (Apr. 11, 1996). In 2007, the CFTC confirmed the continued availability of the relief provided by CFTC Advisory 18-96 for qualifying CPOs. Electronic Filing of Notices of Exemption and Exclusion Under Part 4 of the Commission's Regulations, 72 Fed. Reg. 1658, 1660-1661 (Jan. 16, 2007).

30 The CTA exemption under Regulation 4.14(a)(5) and certain CTA exemptions under Regulation 4.14(a)(8) require that the exempt CTA be providing commodity interest trading advice to an exempt CPO, among other requirements.

31 In the case of a wholly owned subsidiary of a mutual fund, the subsidiary would have disclosure and reporting obligations to its sole shareholder, the mutual fund itself.

32 Form PF will require private funds to disclose certain financial information for use by the Financial Stability Oversight Council (FSOC) in monitoring systemic risk. Form PF will be required only for investment advisers registered with the SEC, although CPOs and CTAs registered with both the SEC and the CFTC will also need to complete this form. Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, SEC Release No. IA-3308 (Oct. 31, 2011). For a discussion of Form PF, refer to SEC and CFTC Adopt Private Fund Systemic Risk Reporting on Form PF, *DechertOnPoint* (December 2011) *available at* http://www.dechert.com/SEC_and_CFTC_Adopt_Private_Fund_Systemic_Risk_Reporting_on_Form_PF_12-06-2011/

33 17 C.F.R. § 4.12.

lack of transparency and heightened concerns regarding systemic market stability.

Understanding that such disclosures contain valuable and non-public information, the CFTC stated that it has examined issues of confidentiality regarding these disclosures, and determined that the proprietary information provided by these forms would not be subject to release under the Freedom of Information Act.

Overview and Changes to Forms

As proposed, Form CTA-PR was comprised of two schedules. Schedule A required general disclosure, including total assets directed by the CTA. Schedule B required more detailed disclosure, including position, performance, and trading strategy information for each of the CTA's trading programs.[34] Many commenters argued that the required information was duplicative of other reporting obligations and urged the CFTC to eliminate the form in its entirety. In response to commenters' concerns, the CFTC did not adopt Schedule B, thereby limiting the information collected from registered CTAs to demographic data and the names of commodity pools advised by the CTA. CTAs will be required to file Form CTA-PR on an annual basis within 45 days of the end of their fiscal years.

Form CPO-PQR is comprised of three schedules. All proposed sections of Form CPO-PQR were adopted, but important changes were made in response to comments, as discussed below.

- Schedule A, Part 1 requires general disclosure similar to that required on Schedule A of Form CTA-PR, and in Part 2 requires disclosure of information regarding each of the CPO's commodity pools, including monthly and quarterly performance information and redemption terms and restrictions. A separate Part 2 must be filed for each pool operated by the CPO. As proposed, Schedule A included a question regarding position information. The final rule moves this question to Schedule B so that Schedule A only solicits general demographic data.

- Schedule B requires more detailed disclosure concerning the pools operated by the CPO, including investment strategy, borrowings, types of creditors, counterparty credit exposure, trading and clearing mechanisms, and a schedule of investments.

- Schedule C is composed of two parts and is required only for the largest CPOs. Part 1 requires aggregate information concerning all of the pools advised by the CPO, including a geographical breakdown of the pools' investments and the pools' turnover, among other information. Part 2 requires similar separate disclosures for each pool advised by the CPO with a net asset value of $500 million or more (either individually or when aggregated with certain parallel pool structures), as well as additional disclosure regarding collateral practices of the pool, liquidity information, counterparty credit exposures, risk metrics, borrowing information, investor composition, financing liquidity information, and duration.

The CFTC received comments requesting clarification of the filing obligations for CPOs and CTAs that are required to file SEC Form PF. Commenters argued that advisers to mutual funds that are required to file Form PF should not be required to report similar information on Form CPO-PQR. Commenters further requested streamlined reporting obligations and questioned whether all of the data on the forms was necessary for the CFTC's oversight of its registrants. Under the final rules, CPOs that are dually registered with the SEC and CFTC and that file Form PF with the SEC must file Schedule A of Form CPO-PQR, but need not file Schedules B and C. Although the CFTC planned for the new Form CPO-PQR to parallel Form PF, the new Form CPO-PQR covers certain material that differs from Form PF and is required to be filed on different timelines than Form PF. This will increase the burden for dual registrants with the CFTC and SEC. In addition, based on the CFTC's position stated elsewhere in the Adopting Release that CFCs wholly owned by mutual funds and used for trading commodity interests are commodity pools, it would appear that a CPO to a mutual fund with one of these CFC structures would be required to report the CFC as a commodity pool in the CPO's reports to the CFTC and SEC on Form CPO-PQR and Form PF, as applicable.

Form CPO-PQR Filing Thresholds and Schedules

In balancing its systemic risk concerns with the cost of compliance, the CFTC adopted a tiered system of regulation with more frequent and detailed disclosures required for larger CPOs. The final rules require CPOs with less than $150 million assets under management (AUM) (small CPOs) to file only Schedule A. CPOs with

34 2011 Proposing Release at 7978.

between $150 million and $1.5 billion AUM (mid-size CPOs) are required to file Schedules A and B. CPOs with over $1.5 billion AUM (large CPOs) must file all three Schedules.

Commenters suggested that the proposed $150 million AUM threshold for filing Schedule B was too low, but the CFTC noted that this threshold is consistent with Section 1 of Form PF, which is similar in substance to Schedule B. The proposed reporting threshold for large CPOs was $1 billion AUM, and commenters suggested that the CFTC increase this threshold to $5 billion. Ultimately, the CFTC increased the threshold to $1.5 billion, in part to make the threshold consistent with the threshold for large hedge fund advisers that must file an additional section of Form PF, noting that any increase beyond that threshold could limit the CFTC's ability to conduct its market oversight role.

The CFTC also modified the reporting frequency for small and mid-size CPOs. The proposed rules required all CPOs to file Schedule A quarterly and mid-size CPOs to file Schedule B annually. In response to comments about the burden imposed by Form CPO-PQR, the final rules adopted by the CFTC require small and mid-size advisers to file Schedule A annually, rather than quarterly. The CFTC also extended the proposed reporting deadlines, which initially required Form CPO-PQR filings within 15 days of the end of the reporting period. Under the final rules, small and mid-size CPOs must submit their annual filings within 90 days of the end of the calendar year. Large CPOs, which are required to file Schedules A, B, and C quarterly, must file all parts of Form CPO-PQR within 60 days of the end of each reporting period.[35]

The final rules also permit, but do not require, affiliated CPOs to file a single Form CPO-PQR on behalf of all affiliates and the commodity pools they operate. Finally, the adopted rules clarify reporting responsibilities for co-CPOs of a pool. The CFTC amended the instructions to Form CPO-PQR to specify that, for co-CPOs, the CPO with the greatest AUM overall is required to report for the co-operated pool. The CFTC added a corresponding question to Schedule A of Form CPO-PQR asking whether the pool is operated by co-CPOs and requiring the names of the other CPOs.

[35] The Adopting Release does not explicitly state that the fourth quarter (or year-end) Form CPO-PQR report for large CPOs must be filed within 60 days of year-end, only that each of such reports must be filed within 60 days of the end of the reporting period.

Figure 1: Reporting Thresholds and Filing Schedules and Deadlines for Form CPO-PQR

CPOs				
	PQR Schedule A	**PQR Schedule B**	**PQR Schedule C**	**First Filing Due**
CPO with at least $1.5 billion AUM	Quarterly filing within 60 days of each calendar quarter-end	Quarterly filing within 60 days of each calendar quarter-end	Quarterly filing within 60 days of each calendar quarter-end	If over $5 billion of AUM as of June 30, 2012, filing due November 29, 2012
				If less than $5 billion of AUM as of June 30, 2012, filing due March 1, 2013
CPO with at least $150 million and less than $1.5 billion AUM	Annual filing within 90 days of calendar year-end	Annual filing within 90 days of calendar year-end	-----	April 1, 2013 (since March 31 is a Sunday)
CPO with less than $150 million AUM	Annual filing within 90 days of calendar year-end	-----	-----	April 1, 2013 (since March 31 is a Sunday)

New Swap Transaction Risk Disclosure Statements for CPOs and CTAs

Under the final rules, CPOs and CTAs will be required to add a specific standardized risk disclosure concerning swaps in the mandatory risk disclosure statement already required in CFTC Regulations 4.24 and 4.34 at the beginning of CPO and CTA disclosure documents.[36] The newly required disclosure states that all swap transactions present, among other risks, market, credit, counterparty credit, funding, liquidity, and operational risks. The disclosure also identifies highly customized swap transactions in particular as potentially increasing

[36] 17 C.F.R. §§ 4.24, 4.25, and 4.34.

liquidity risk and highly leveraged transactions as potentially increasing risk of loss in value. The disclosure states that swaps may be modified or terminated only by mutual consent of the original parties.

In response to industry comments that a standardized risk disclosure is inappropriate and inconsistent with SEC guidance to mutual funds to avoid generic disclosures, [37] the CFTC stated that its standardized risk disclosure addressing the use of swaps is necessary due to the statutory definitions of CPO, CTA, and commodity pool enacted by the Dodd-Frank Act. The CFTC also noted that registrants' risk disclosure is not limited to the standard CFTC disclosure, that registrants can also present more tailored risk disclosure elsewhere in their disclosure documents, and that the standardized disclosures "do not purport to apply in all circumstances." The CFTC also stated that any conflicting requirements imposed on mutual funds whose advisers are required to register as CPOs as a result of the amendments to CFTC Regulation 4.5 will be addressed through the harmonization of the CFTC's and SEC's compliance regimes. However, the Harmonization Proposing Release (defined below) does not in fact address this conflict between the SEC's guidance that mutual funds must avoid standardized risk disclosure and the CFTC's new standardized risk disclosure requirements.

The CFTC's required swap risk disclosure is in addition to, not in place of, more tailored disclosure of actual and potential risks of swap investing relevant to particular commodity pools or trading programs. Registered CPOs and CTAs must include the standardized swap risk disclosure in all new and updated disclosure documents filed on and after April 24, 2012.

Fund-of-Funds Issues

In connection with rescinding CFTC Regulation 4.13(a)(4), the CFTC addressed comments requesting that the exemption from CPO registration under Regulation 4.13(a)(4) be retained for a CPO to a fund that only invests in commodity interests indirectly by utilizing a fund-of-funds structure. The CFTC noted that, because many CPOs were exempt under the current rules, it does not have sufficient information to create such an exemption. Instead, the CFTC will wait to consider this request until it has received sufficient data under the new rules from CPOs to funds-of-funds on CFTC Form CPO-PQR. The CFTC also noted that its staff will be willing to consider requests for exemptive relief for certain funds-of-funds on a case-by-case basis.

In connection with adopting CFTC Regulation 4.27 and the related new reporting obligations on CFTC Forms CPO-PQR and CTA-PR, the CFTC also responded to a comment unique to funds-of-funds. One commenter argued that a fund-of-funds that invests in an unaffiliated commodity pool is not "in the business of trading commodity interests" and is therefore not a commodity pool for purposes of the CEA. In response, the CFTC reiterated its long-standing policy that "it is the position of the [CFTC] that a fund investing in an unaffiliated commodity pool is itself a commodity pool," which the CFTC identified as consistent with the definition of commodity pool under the CEA, which "draws no distinctions between direct and indirect investments in commodity interests." The CFTC stated that any other result would create incentives to avoid direct investment in commodity interests and could decrease transparency in the market. The commenter also asserted that the investee pool's regulation by the CFTC or SEC renders reporting by the fund-of-funds unnecessary, in response to which the CFTC noted that the fund-of-funds could invest in a commodity pool with an exempt CPO, which necessitates reporting at the fund-of-funds level.

Notwithstanding the CFTC position that indirect commodity interest investment through a fund-of-funds structure could trigger CPO registration for the operator of the fund-of-funds, the Adopting Release did not provide explicit guidance as to how mutual funds that are fund-of-funds investing in commodity pools should measure their exposure for the 5% Trading Test and Net Notional Test in amended Regulation 4.5. It is expected that the CFTC will provide this guidance at a future date. The CFTC has previously provided similar guidance in the context of Regulation 4.13(a)(3). [38]

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37 *See* Letter from Barry D. Miller, Associate Director, Office of Legal and Disclosure of the SEC Division of Investment Management, to Karrie McMillan, General Counsel, Investment Company Institute (July 30, 2010), available at http://www.sec.gov/divisions/investment/guidance/ici073010.pdf. *See also* Plain English Rule, 17 C.F.R. § 421(d) ("Using all capitalized letters for the legends does not give them proper prominence. Rather, it makes them hard to read." Plain English Disclosure, SEC Release No. 33-7497 at 11 (Jan. 28, 1998)).

38 17 C.F.R. Appendix to Part 4 – Guidance on the Application of Regulation 4.13(a)(3) in the Fund of Funds Context.

The same commenter noted a concern that an investing fund-of-funds may not have access to the information necessary to respond to all of the data elements in the schedules to Form CPO-PQR. In response, the CFTC included tailored reporting requirements to accommodate funds-of-funds, and characterized those rules as consistent with the reporting requirements under SEC Form PF. In that regard, the final rules add a single general question to Schedule A of Form CPO-PQR relating specifically to investee funds and the size of a fund-of-funds' investments in other funds, but otherwise permits a CPO to disregard the assets of such investee funds for reporting purposes.[39] The final rules also add an instruction to Form CPO-PQR providing that if any commodity pool invests only in other pools or private funds (except for cash, cash equivalents, and instruments intended to hedge currency risk), the CPO is only required to complete Schedule A of Form CPO-PQR for that fund-of-funds and otherwise may disregard such assets for reporting purposes.

Proposed Harmonization Rules

Many industry members commented on the duplicative, inconsistent, and conflicting requirements of the CFTC's rules for commodity pools and the SEC's rules for mutual funds.[40] In order to facilitate compliance by mutual funds with the CFTC's disclosure, reporting, and recordkeeping requirements, the CFTC has proposed harmonizing certain SEC and CFTC rules. These proposed amendments aim to more closely align the CFTC's requirements with those placed on mutual funds by the SEC.[41]

Some of the requirements addressed in the proposed harmonization provisions include:

- the timing and delivery of disclosure documents;
- the signed acknowledgement requirement for disclosure documents;
- the timing of financial reporting to shareholders;
- the requirement that a CPO maintain its books and records at its main business address;
- the timing of the cycle for updating disclosure documents; and
- the requirement that the NFA approve a prospectus supplement before effectiveness.

The proposed harmonization provisions also address certain CFTC disclosure requirements that either overlap or are inconsistent with SEC rules regarding the content of prospectuses and summary prospectuses, including: the CFTC requirement that a CPO show similar pool performance for pools in operation for less than three years; the requirement to include a "break-even point" and certain other additional fee information in the forepart of the disclosure document; and the inclusion of mandatory certification language.

Extension of Exemptive Relief Previously Provided to ETFs. Several of the provisions at issue for mutual funds were addressed in a recent CFTC rulemaking providing exemptive relief to exchange-traded commodity funds (ETFs) under CFTC Regulation 4.12(c).[42] At the suggestion of some commenters, the CFTC proposed extending this exemptive relief to mutual funds by amending Regulation 4.12(c) so that the CPO of any commodity pool registered under the Securities Act will be eligible to claim the available relief.[43]

39 However, a CPO may not then treat the excluded assets inconsistently by including the same assets on the reporting form for other purposes (*e.g.*, responses to questions regarding borrowing), with certain exceptions, and a CPO may not disregard the liabilities of the fund-of-funds, even if incurred in connection with investments in an underlying fund.

40 *See, e.g.*, Dechert July 2011 Comment Letter at 22.

41 Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators, 77 Fed. Reg. 11345 (Feb. 24, 2012) (to be codified at 17 C.F.R. § 4) (Harmonization Proposing Release).

42 Commodity Pool Operators: Relief From Compliance With Certain Disclosure, Reporting and Recordkeeping Requirements for Registered CPOs of Commodity Pools Listed for Trading on a National Securities Exchange; CPO Registration Exemption for Certain Independent Directors or Trustees of These Commodity Pools, 76 Fed. Reg. 7696 (May 18, 2011). For further information, refer to CFTC Proposes Relief from Certain Disclosure, Reporting and Recordkeeping Requirements for CPOs of Commodity ETFs, *DechertOnPoint* (Oct. 2010) *available at* http://www.dechert.com/CFTC_Proposes_Relief_from_Certain_Disclosure_Reporting_and_Recordkeeping_Requirements_for_CPOs_of_Commodity_ETFs_10-05-2010/

43 Mutual funds would be able to claim the relief by electronically filing a claim of exemption with the NFA, containing certain information and representations. The claim of exemption would be effective upon filing. 17 C.F.R. § 4.12(d).

The requirements for which relief is provided in Regulation 4.12(c) include the following:

Prospectus and Account Statement Delivery Requirements. CFTC Regulation 4.21 requires that a CPO deliver a disclosure document to a prospective commodity pool participant and receive a signed acknowledgment of receipt, prior to accepting any funds, securities, or other property from the prospective participant. Applying this provision to mutual funds would likely preclude the offer and purchase of their shares on certain platforms, increase transfer agency burdens and costs (which are ultimately borne by shareholders), and unnecessarily delay initial investments. However, under proposed Regulation 4.12(c), a mutual fund would be permitted to meet the delivery requirements of Regulation 4.21 by making its disclosure documents available online.

Similarly, the CFTC Regulation 4.22(a) requirement to deliver monthly account statements to commodity pool investors may also be met by posting these statements online. Although mutual funds currently only provide reports to shareholders semi-annually, and some commenters suggested that requiring monthly statements could be burdensome to mutual funds, the CFTC determined not to provide relief from this monthly requirement, as it believes the information required to prepare the statement should be readily available to the CPO of a mutual fund that is in compliance with recordkeeping rules. However, the CFTC proposed permitting a mutual fund to make the monthly statement available online.

Maintenance of Books and Records. Under CFTC Regulation 4.23, a CPO must make and keep its books and records "at its main business office." As several commenters pointed out, the records of mutual funds are often maintained by third-party administrators. The proposed relief under Regulation 4.12(c) would permit a mutual fund to maintain its records with specified third parties, including administrators, provided that certain information and representations are filed with the CPO's notice claiming relief under the regulation.

Disclosure Requirements.

Although the CFTC believes that CPO disclosure requirements are generally consistent with SEC requirements, the Harmonization Proposing Release highlighted a few instances where conflicts in disclosure were indentified, including the following:

Past Performance. CFTC Regulation 4.25(c) requires commodity pools that have been trading commodity interests for three years or more to show the past performance of the pool and, for pools that have been in operation for less than three years, to show the past performance of similar pools, in accordance with the directions provided. These requirements are in conflict with certain SEC prohibitions on the disclosure of past performance.[44] The CFTC stated in the Harmonization Proposing Release that it had preliminary discussions with the SEC staff on this issue, and would be willing to accept inclusion of this disclosure in a mutual fund's statement of additional information, rather than in its prospectus. The CFTC reported that the SEC has indicated that it will entertain no-action letters from affected mutual funds if necessary and appropriate. The CFTC is seeking comment on this issue.

Break-even Point and Other Fee and Expense Disclosures. CFTC Regulation 4.24(d)(5) requires that a commodity pool include in the "forepart" of its disclosure document a tabular presentation of the calculation of the pool's "break-even point."[45] Although not required by SEC rules, including such information in a statutory prospectus would not be precluded; however, the break-even point could not appear in the summary prospectus portion of the registration statement. The SEC has strictly proscribed the permitted contents of a summary prospectus to include only the content required under Items 1-8 of Form N-1A.[46] The CFTC addressed this issue by proposing to consider the section immediately following the summary section of a mutual fund prospectus as part of the "forepart" of the document. A mutual fund could then include the break-even point in a section of the pros

44 The SEC prohibits inclusion of past performance of a fund sponsor unless one fund is substantially similar to the other fund, but Regulation 4.25(c) requires all of such past performance, whether substantially similar or not. *Nicholas-Applegate Mutual Funds*, SEC No-Action Letter (pub. avail. Aug. 6, 1996).

45 17 C.F.R. § 4.10(j) defines 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] pursuant to section 17(j) of the [CEA]." The break-even point must be expressed in terms of dollars and as a percentage of the minimum unit of initial investment. It must also assume the redemption of the investment as of the close of the first year of investment.

46 17 C.F.R. §270.498. The summary prospectus may be subject to further changes under the Dodd-Frank Act.

pectus immediately following the summary prospectus. Any other fee information required by Regulation 4.24(d) but not included in the summary prospectus fee table required by Item 3 of Form N-1A would also be included immediately following the summary section of the prospectus. The CFTC considers the disclosures required by Regulation 4.24(d) to be necessary disclosures, as they require a greater level of detail regarding brokerage fees than otherwise required by Form N-1A and do not assume a specific rate of return.

Other Registration and Delivery Requirements

Other CFTC requirements addressed in the Harmonization Proposing Release include the following:

Timing of Prospectus Updates. Some commenters noted that the CFTC's and SEC's timing requirements for updating disclosure documents are inconsistent. While Section 10(a)(3) of the Securities Act provides a deadline of 16 months for updating prospectuses (ultimately resulting in an annual update cycle due to the inclusion of financial statements, which are prepared annually), CFTC Regulation 4.26 requires disclosure documents to be updated every nine months. To address this inconsistency, the CFTC proposed that all CPOs and CTAs, not solely those operating or advising a mutual fund, file updates of disclosure documents 12 months from the date of the document.

NFA Review of Prospectus Supplements. Some commenters, including the NFA, noted that under current rules a prospectus supplement would need to be filed with and accepted by the NFA before it could be distributed. This presents an obstacle for open-end mutual funds that are already in operation because they are continuously offered. The NFA proposed that commodity pools that provide for daily liquidity be permitted to post their amended disclosure document, with changes highlighted, on their website at the same time that the CPO files the supplement with the NFA, and then file the final document after it has been approved. The CFTC noted that Regulation 4.26(d)(2) already permits this. Therefore CPOs may follow the procedure suggested by the NFA without any additional action by the CFTC.

Certifications and Cautionary Statements. Commenters noted minor differences between the standard CFTC and SEC cautionary statement required to be included on the front cover of a disclosure document. Commenters also noted differences between the standard certification provided with account statements to commodity pool participants and semi-annual reports provided to mutual fund investors. The CFTC proposed accepting the certification provided for in SEC Form N-CSR in lieu of that required by CFTC Regulation 4.22(h).[47] However, the CFTC will require that the certification be provided to investors, and not just through EDGAR. For the cover page of a prospectus, the CFTC proposed that a mutual fund use a cautionary statement that combines the language required by CFTC Regulation 4.24(a) and Regulation 481(b)(1) under the Securities Act.

Compliance and Cost Burden and Comment Period

In the Harmonization Proposing Release, the CFTC estimated a two-hour per year compliance burden for mutual funds to meet the proposed requirements, which is obviously significantly understated. The CFTC is seeking comments on all of the above-proposed harmonization provisions, as well as suggestions regarding any other provisions that may require harmonization.

Market participants that anticipate being affected by the changes to the finalized Part 4 Regulation changes and the Harmonization Proposing Release should consider submitting a comment letter to the CFTC during the comment period that ends April 24, 2012.

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47 The second item in a mutual fund's annual report officer certifications reads, "Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report." Form N-CSR, Certifications.

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