Compliance Obligations Facing Investment Advisers Registered as Commodity Pool Operators with Respect to a Registered Investment Company

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Introduction

In August of 2013, the Commodity Futures Trading Commission ("CFTC") adopted rules ("Harmonization Rules") to harmonize the compliance obligations of investment advisers required to register as commodity pool operators ("CPOs") of registered investment companies ("Registered Funds").[1] The Harmonization Rules permit CPOs of Registered Funds ("Registered Fund CPOs") to claim broad relief from certain of the disclosure, reporting and record keeping requirements in Part 4 of the CFTC's regulations ("Part 4"), conditioned largely on the Registered Fund's continued compliance with applicable securities laws and regulations.[2] The Harmonization Rules apply only to investment advisers of Registered Funds unable to claim the exclusion available under CFTC Rule 4.5.[3]

Although Registered Fund CPOs are the primary focus of the Harmonization Rules, the CFTC used the Harmonization Rules to liberalize certain compliance obligations for all CPOs and commodity trading advisors ("CTAs") and to provide exceptions from other compliance obligations for all CPOs, but not CTAs. In this regard, the Harmonization Rules have an impact that stretches beyond Registered Fund CPOs.

At the same time the CFTC adopted the Harmonization Rules, the staff of the Division of Investment Management (the "IM Staff") of the U.S. Securities and Exchange Commission ("SEC") published an IM Guidance Update entitled *Disclosure and Compliance Matters for Investment Company Registrants That Invest in Commodity Interests*.[4] The Guidance Update was intended in part to facilitate compliance with SEC and CFTC disclosure requirements.

This article provides an overview of the Harmonization Rules and highlights some of the difficulties that Registered Fund CPOs may encounter in complying with the Harmonization Rules.

"Substituted Compliance" for Registered Fund CPOs

The CFTC's primary rationale for adopting the Harmonization Rules was its conclusion that the disclosure and reporting requirements of the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act"), the Investment Company Act of 1940 ("Investment Company Act"), the rules and regulations promulgated under each of the foregoing and accompanying SEC staff guidance (collectively, "Securities Laws") applicable to Registered Funds are sufficiently robust that compliance with the Securities Laws is an appropriate substitute for compliance with the disclosure and reporting obligations in Part 4 that otherwise would apply to a Registered Fund CPO.[5]

As part of the Harmonization Rules, the CFTC adopted new Rule 4.12(c)(3). The new rule exempts a Registered Fund CPO from the disclosure requirements in CFTC Rules 4.21, 4.24, 4.25 and 4.26, the financial reporting requirements in Rule 4.22 and the specific requirement in Rule 4.23 that otherwise would have required a Registered Fund CPO to allow shareholders to inspect the books and records of the Registered Fund. To rely on the exemption, the Registered Fund CPO must ensure that the Registered Fund's disclosures comply with the requirements of the Securities Laws, that the Registered Fund's "current net asset value" is "available to [shareholders]" and, in limited circumstances, that the Registered Fund CPO discloses the past performance of its other funds and accounts with "substantially similar" investment strategies. We refer to the conditions and exemptions of Rule 4.12(c)(3) as "Substituted Compliance." For most Registered Fund CPOs, Substituted Compliance means that their disclosure and reporting obligations with respect to Registered Funds will remain largely unchanged.

A. Threshold Eligibility Requirement for Substituted Compliance

The threshold eligibility requirement for Substituted Compliance is that the "pool" in question be "registered under the Investment Company Act of 1940."[6] The breadth of this requirement is presumably intended to ensure that Substituted Compliance is available to Registered Fund CPOs without regard to the particular type of fund (e.g., investment company, unit investment trust or face amount certificate company) or the particular characteristics of that fund (e.g., open-end vs. closed-end, publicly offered vs. privately offered, diversified vs. non-diversified), even though the CFTC's guidance in the Adopting Release appears to be directed mostly toward publicly-offered, open-end Registered Funds (i.e., mutual funds).

B. Claiming Substituted Compliance

In order for a Registered Fund CPO to take advantage of Substituted Compliance, it must complete an electronic filing in the National Futures Association's ("NFA") electronic exemption filing system.[7] The exemption filing must be completed by a representative authorized to bind the Registered Fund CPO,[8] and must be submitted prior to the date the Registered Fund enters into its first "commodity interest" transaction (although presumably this requirement was not intended to exclude Registered Fund CPOs that previously relied upon the exclusion in CFTC Rule 4.5, but whose Registered Funds no longer satisfy either the marketing or trading conditions of that exclusion).[9] A Registered Fund CPO's exemption filing must identify every Registered Fund for which it intends to claim Substituted Compliance.[10] The exemption filing becomes effective as soon as it's submitted through the NFA's online system.[11]

C. Substituted Compliance for Disclosure Documents

Substituted Compliance exempts a Registered Fund CPO from the disclosure obligations in CFTC Rules 4.21, 4.24, 4.25 and 4.26. The text of Rule 4.12(c)(3) imposes only two express conditions on these exemptions: first, the Registered Fund must comply with applicable provisions of the Securities Laws; and second, if the Registered Fund has less than a three-year operating history, the Registered Fund CPO must "disclose[] the performance of all accounts and pools" that are "managed" by the Registered Fund CPO and that have "investment objectives, policies, and strategies substantially similar" to those of the Registered Fund.[12] Notwithstanding the plain language of Rule 4.12(c)(3), the CFTC used the Adopting Release to impose additional conditions (in the case of standard cautionary statements) and to provide additional relief (in the case of controlled foreign corporations or "CFCs"), as well as to provide further explanation of the express conditions of Substituted Compliance.

The remainder of this section C discusses the impact of Substituted Compliance on the disclosures that a Registered Fund is required to make in its prospectus.

Continued Use of a Registered Fund's Prospectus and Summary Prospectus

A Registered Fund CPO that uses Substituted Compliance generally will need to make only limited revisions to the prospectuses of its Registered Funds. The Adopting Release also makes clear that Substituted Compliance permits the continued use of a summary prospectus.[13] Accordingly, the basic form and presentation of a Registered Fund's prospectus will remain unchanged under Substituted Compliance.

Process for Reviewing a Prospectus

A registered CPO ordinarily is required to file a pool's Part 4-compliant disclosure document ("Disclosure Document") with the NFA before the Disclosure Document may be used to solicit prospective investors.[14] As part of this process, NFA staff members routinely review the pool's Disclosure Document, comment on the draft and require the CPO to address the staff's comments before the NFA will accept the Disclosure Document as being "filed" with the NFA (which is required to occur prior to the CPO's first use of the Disclosure Document to solicit investors). Substituted Compliance exempts a Registered Fund CPO from the requirement to file a Registered Fund's prospectus with the NFA.[15] Instead, the conditions of Substituted Compliance require a Registered Fund CPO to continue filing the Registered Fund's prospectus with the SEC.[16] In this sense, the process used by a Registered Fund to prepare its prospectus and have it reviewed by regulatory authorities prior to first use will remain unchanged.

The CFTC's "Harmonization Rules" harmonize the compliance obligations of investment advisers required to register as commodity pool operators ("CPOs") of registered investment companies ("Registered Funds").

Because Registered Fund CPOs are exempt from the requirement to file Registered Fund prospectuses with the NFA, neither the staff of the NFA nor the staff of the CFTC will review the sufficiency of the disclosures required to be included as a result of Substituted Compliance. The Adopting Release, however, makes clear that the CFTC expects the NFA staff to examine the prospectuses of Registered Funds relying on Substituted Compliance during routine exams of the Registered Fund CPO.[17] Depending on the implementation of this practice, the NFA's after-the-fact examination of a Registered Fund's prospectus could be a source of concern for Registered Fund CPOs because any deficiency in the prospectus means that the Registered Fund CPO has been in violation of the conditions of Substituted Compliance, and therefore technically not eligible for Substituted Compliance.

Updating a Registered Fund's Prospectus

A registered CPO typically is required to update a Disclosure Document at least annually so that its disclosure is not more than 12 months old. If the CPO discovers any material inaccuracies in a Disclosure Document between updates, the CPO is required to correct the inaccuracies and distribute corrected Disclosure Documents to participants within 21 days. With Substituted Compliance, however, a Registered Fund's prospectus is required to be updated only as frequently as the Securities Laws require.[18] With regard to periodic updates, the Adopting Release expressly recognizes that Section 10(a)(3) of the Securities Act and Rule 485 thereunder allow an open-end Registered Fund to use a prospectus that contains information that is up to 16 months old.[19] As long as this is the "timeframe administered by the SEC," the CFTC deems the 16 month period permissible for purposes of Substituted Compliance.[20] Even though the Adopting Release discusses only open-end Registered Funds, the plain language of Rule 4.12(c)(3)(i)(B) suggests that the CFTC would similarly defer to the "timeframe administered by the SEC" for the periodic updates of any other type of Registered Fund's prospectus.

With regard to interim updates of a Registered Fund's prospectus, the Adopting Release accepts that the Securities Act's general prohibition against offering or selling securities using a prospectus that is materially misleading is sufficient to ensure that Registered Fund CPOs timely update Registered Fund prospectuses that are materially inaccurate or incomplete.

Delivering Prospectuses

Before the CFTC adopted the Harmonization Rules, a registered CPO could not accept a prospective investor into a pool until the registered CPO received a signed and dated acknowledgment from the investor confirming receipt of the

fund's Disclosure Document. [21] As part of the Harmonization Rules, this requirement is now deleted for all CPOs (not just Registered Fund CPOs relying on Substituted Compliance). Accordingly, a Registered Fund will continue to distribute its prospectus as required by Section 5 of the Securities Act and any regulations applicable to the particular type of Registered Fund.

Disclosure of Fees and Expenses

Without Substituted Compliance, a pool's Disclosure Document must include the "break-even point" per unit of initial investment,[22] as well as a description of each fee, commission and other expense that has been incurred by the pool or that the pool's CPO expects to be incurred.[23] If a Registered Fund CPO claims Substituted Compliance, it can continue to present the fees and expenses associated with an investment in a Registered Fund in accordance with the form requirements applicable to the particular type of Registered Fund.

New Cautionary Statement Must Be Added to Prospectus Cover Page

A pool's Disclosure Document typically is required to disclose on the outside cover page the cautionary statement prescribed by CFTC Rule 4.24(b)(1). Substituted Compliance requires that a Registered Fund CPO disclose on the outside cover page of the Registered Fund's prospectus a modified version of the cautionary statement prescribed by Securities Act Rule 481(b)(1).[24] The CFTC has expressly approved the use of either of the following versions of the statement:

Example A:

"The Securities and Exchange Commission and the Commodity Futures Trading Commission have not approved or disapproved these securities or passed upon the adequacy of this prospectus. Any representation to the contrary is a criminal offense."

Example B:

"The Securities and Exchange Commission and the Commodity Futures Trading Commission have not approved or disapproved these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense."[25]

The SEC's Guidance Update indicated that these modified legends are permissible under the Securities Laws.

Risk Disclosure Concerning Commodity Interests

Without Substituted Compliance, a registered CPO is required to include on the cover of a pool's Disclosure Document the standard risk disclosure statement prescribed by Rule 4.24(b). In addition, a pool's Disclosure Document ordinarily must include a discussion of the principal risk factors of an investment in the pool, including a discussion of the particular risk factors of "commodity interest" trading (e.g., volatility, leverage, liquidity, counterparty creditworthiness). Substituted Compliance exempts a Registered Fund CPO from including the Rule 4.24(b) standard risk disclosure statement on the cover of the Registered Fund's prospectus. In the adopting Release, the CFTC recognized that the risk disclosures required by the Securities Laws, including disclosure requirements under Section 10 of the Securities Act, and the other disclosure requirements under the Securities Laws provide sufficient disclosure of a Registered Fund's principal risk factors.

On this particular issue, the Guidance Update reiterated the concern of the IM Staff that Registered Funds adequately disclose the risks associated with investments in commodity interests. The IM Staff reminded registrants that disclosure relating to principal investment strategies involving derivatives, including commodity interests, should be specifically tailored to how a Registered Fund will use derivatives (e.g., hedging, speculation, as a substitute for traditional securities), and the extent to which a Registered Fund expects to invest in derivatives. The IM Staff emphasized that derivatives disclosure should not be generic in nature. The IM Staff also reminded registrants that disclosure relating to derivatives should adequately describe material risks attendant to the Registered Fund's use of derivatives, including a discussion of the risks related to volatility, leverage, liquidity and counterparties.

Past Performance of Other Accounts and Pools

Without Substituted Compliance, the Disclosure Document of a pool with less than three years operating history is required to include the past performance of all other accounts and pools managed by the pool's CPO.[26] Substituted Compliance narrows this requirement so that a Registered Fund CPO is only required to disclose the past performance of the other accounts and pools it manages and that have "investment objectives, policies, and strategies substantially similar

to those of the offered pool."[27] For most Registered Fund CPOs relying on Substituted Compliance, the most time-consuming aspect of satisfying this condition of eligibility will be determining which, if any, other pools and accounts have substantially similar investment policies, objectives and strategies, and what the implications are of disclosing such performance in a publicly available document.

The CFTC's primary rationale for adopting the Harmonization Rules was its conclusion that the disclosure and reporting requirements of the … "Securities Laws" applicable to Registered Funds are sufficiently robust that compliance with the Securities Laws is an appropriate substitute for compliance with the disclosure and reporting obligations in Part 4 that otherwise would apply to a Registered Fund CPO.

In the Adopting Release, the CFTC provides no insight into the criteria that a Registered Fund CPO should use to identify pools with investment objectives, policies and strategies that are substantially similar to those of an offered Registered Fund. Although the CFTC recognizes the inherent subjectivity in any such analysis, it believes that such subjectivity in the guidance previously issued by the IM Staff in no-action letters "is tightly constrained."[28] However, neither of the letters to which the CFTC cited – *ITT Hartford Mutual Funds* or *Nicholas-Applegate Mutual Funds* – yields much in the way of instruction on this issue.[29]

ITT Hartford Mutual Funds concerned a situation in which an adviser, ITT Hartford, created a publicly offered version for each of six existing funds, none of which could be publicly offered itself because of then-existing tax laws.[30] Other than the fact that one fund was being offered publicly and the other was not, there was no apparent difference in the investment objectives, policies or strategies between the two funds. Subject to numerous conditions on the presentation of the past performance of the non-public fund, the IM Staff permitted ITT Hartford to use each non-public fund's past performance in the prospectus of the corresponding public fund.

In *Nicholas-Applegate Mutual Funds*, an adviser, Nicholas-Applegate Capital Management ("NACM"), sought to include in the prospectuses of various funds the past performance of similarly managed accounts beyond the first year of the fund's operation. NACM had included the accounts' past performance in reliance on an earlier staff no-action letter, *Growth Stock*,[31] which permitted the presentation of past performance of a managed private account in the prospectus of a closed-end fund, provided that (i) the performance was for all of the adviser's private accounts that were managed with investment objectives, policies and strategies substantially similar to those used in managing the closed-end fund; (ii) the relative sizes of the closed-end fund and the private accounts were sufficiently comparable to ensure that the private accounts' performance would be relevant to a potential fund investor; and (iii) the prospectus clearly disclosed that the performance information related to the adviser's management of private accounts and that such information should not be interpreted as indicative of the fund's future performance. In *Nicholas-Applegate Mutual Funds*, the IM Staff did not provide any further guidance or interpretation of the key phrase "investment objectives, policies and strategies substantially similar;" rather, it simply noted that the Investment Company Act did not expressly prevent the inclusion of the accounts' past performance, provided that such performance was not materially misleading.

The Guidance Update referenced the *ITT Hartford* and *Nicholas-Applegate Mutual Funds* no-action letters, but also included cautionary reminders from the IM Staff to present performance information from other funds and accounts in a way that is not incomplete, inaccurate or misleading and does not, because of its nature, quantity or manner of presentation, obscure or impede understanding of information actually required by the applicable disclosure form. In particular, the IM Staff reminded Registered Funds to include the performance information from all funds and accounts managed by the registrant's investment adviser with substantially similar investment objectives, policies and strategies and not to cherry pick only those funds and accounts with superior performance.

In addition to not providing clear guidance on how to determine whether investment objectives, policies and strategies are substantially similar, the Adopting Release does not specify how or where such past performance should be disclosed. Given the CFTC's deference to the Securities Laws throughout

the Adopting Release, it seems reasonable for Registered Fund CPOs to present the past performance of other accounts and pools in any manner permitted by the disclosure form applicable to the Registered Fund including, if permitted, in the Registered Fund's statement of additional information.[32] In order to ensure that any such disclosure is not misleading, it should be accompanied by appropriate cautionary statements disclosing that past performance does not ensure future results and describing any facts or circumstance necessary to place the performance information in context, such as differences in the sizes of the funds or accounts or the market conditions in which the past performance was achieved.

The information relating to the past performance of other funds and accounts managed by a Registered Fund CPO raises an issue with respect to liability for such information. The performance information required to be disclosed cannot be derived from information about the Registered Fund. By definition, it is information about the Registered Fund CPO and other funds and accounts that the Registered Fund CPO manages. Registered Funds and their boards and CCOs should, at a minimum, put in place policies and procedures to ensure the accuracy of any such information included in the Registered Fund's disclosure documents and may wish to enter into agreements pursuant to which the Registered Fund is indemnified by the Registered Fund CPO from any liability arising concerning the accuracy and completeness of such information.

Additional Disclosures Concerning Controlled Foreign Corporations

In the Adopting Release, the CFTC restates its earlier position on controlled foreign corporations ("CFCs"). The CFTC continues to view CFCs as commodity pools if they use commodity interests, and absent the ability of the operator of the CFC to claim the exemption in Rule 4.7, the CFTC expects such operator to register as a CPO and to produce a Disclosure Document for the CFC.[33] However, in order to avoid producing a Disclosure Document for the CFC, the CFTC would allow a Registered Fund CPO to include in the prospectus of the Registered Fund "full disclosure of material information regarding the activities of [the Registered Fund's] CFC."[34]

The Adopting Release does not explain what constitutes "full disclosure of material information." The CFTC does cite as a basis for its position that Items 4, 9 and 16(b) of Form N-1A and Items 8 and 17 of Form N-2 require a Registered Fund to disclose "information about the [Registered Fund's] investments in the CFC and the principal risks associated with the CFC investments, including those related to swaps and other commodity interests."[35] Noting that the CFTC cites to these requirements without claiming they are incomplete or deficient, a Registered Fund CPO should revisit existing disclosures concerning CFCs in each Registered Fund's prospectus to ensure that such disclosures satisfy the requirements of Forms N-1A or N-2.

In addition to the relief granted through the Adopting Release, Registered Fund CPOs should recall that in circumstances where the CPO of a CFC is controlled by, controlling or under common control with the Registered Fund CPO, existing Rule 4.21(a)(2) generally would exempt the CFC's CPO from being required to produce a separate Disclosure Document for the CFC.[36]

Series Companies

In a 2010 no-action letter, CFTC staff determined that a series limited liability company, as opposed to each of the individual series thereof, is the legal "commodity pool" for which a Disclosure Document must be produced. Accordingly, absent no-action relief, a Disclosure Document for a series company must include information about each of the individual series of the series company. In the Adopting Release, the CFTC makes clear that Registered Fund CPOs relying on Substituted Compliance are expected to adhere to the SEC's guidance concerning disclosure for Registered Funds organized as series companies, which would permit each series company to use its own prospectus or to share a prospectus with one or more other series of the registrant at the discretion of the funds' investment adviser.

Additional Liability Considerations with Substituted Compliance

One key consideration for Registered Fund CPOs that have taken advantage or anticipate taking advantage of Substituted Compliance is that the exemptions therein have been conditioned upon a Registered Fund's continued compliance with all applicable disclosure provisions of the Securities Laws.[37] As a result, a violation of any applicable disclosure requirement of the Securities Laws technically could render a Registered Fund CPO ineligible for the exemption in Rule 4.12(c)(3).[38] Interpreted strictly, this condition could result in the (presumably unintended) consequence of a comparatively minor violation of the Securities Laws disclosure requirements immediately resulting in a Registered Fund CPO being in violation of the

disclosure requirements of Part 4.[39] It would seem, however, that such a rigid interpretation of the conditions of Rule 4.12(c)(3) by either the CFTC or the NFA would contradict to the general spirit of the Harmonization Rule.

D. Substituted Compliance for Financial Reporting

A registered CPO is required to deliver monthly account statements to each pool participant and to deliver/file audited annual reports in the form prescribed by Rule 4.22(c) to each pool participant and the NFA.[40] Substituted Compliance exempts a Registered Fund CPO from these financial reporting obligations, provided that the Registered Fund CPO "causes the [Registered Fund's] current net asset value to be available to [shareholders]" and the Registered Fund's annual financial statements are filed with the NFA.[41]

For open-end Registered Funds, there is little question about the availability of "current net asset value" to shareholders. The Investment Company Act generally requires that open-end Registered Funds calculate their net asset value on each business day. Further, the Adopting Release specifically discusses the requirement for open-end Registered Funds to "sell and redeem shares based on the current net asset values of those shares," and notes that "[those] net asset values may be posted on the [Registered Fund's] website or otherwise made available to investors."[42] Accordingly, it appears that the CFTC presumes that most open-end Registered Funds already satisfy the "current net asset value" condition of Substituted Compliance.

For closed-end Registered Funds, the availability of "current net asset value" requires *interpretation.*[43] *Even though the Adopting Release at various points discusses the applicability* of Substituted Compliance to closed-end Registered Funds, the CFTC does not provide any insight into how "current net asset value" is expected to be interpreted in the context of a closed-end Registered Fund. The CFTC included the requirement to make current net asset value available because, when coupled with the annual and semi-annual reports required to be filed with the SEC on Form N-CSR, "the [CFTC] believes that the decision not to require monthly statements would not reduce the transparency available to investors."[44] For the CFTC, an important consideration is that a fund investor has sufficient information to calculate the value of his investment using the per share net asset value.[45] Recognizing that commodity pools whose CPOs are fully subject to Part 4 would provide investors with a per share net asset value on a monthly basis, it seems reasonable to presume that a closed-end Registered Fund that publishes a per share net asset value at least monthly would address the CFTC's concerns about sufficient shareholder information being available under Substituted Compliance.

In addition to making a Registered Fund's current net asset value available to investors, the CFTC indicated in the Adopting Release that it expects a Registered Fund CPO to file with the NFA the annual report filed with the SEC on Form N-CSR. Interestingly, this expectation is not codified as a rule and the section of the Adopting Release dedicated to "Financial Reporting" does not discuss or explain this expectation. The CFTC has not explained whether the NFA has any additional responsibilities beyond simply receiving a Registered Fund's SEC annual report (e.g., whether NFA's staff would be examining such filings for sufficiency).

The CFTC also stated in the Adopting Release that if the financial statements of a CFC are consolidated into the financial statements of a Registered Fund, the CFC is not required to file separate financial statements with the NFA.[46]

E. Substitute Compliance for Recordkeeping

Rule 4.23 requires a registered CPO to make its books and records concerning a pool open for inspection by participants in that pool. Substituted Compliance exempts a Registered Fund CPO from making the records of the Registered Fund available for inspection by shareholders of the Registered Fund.

General Exemption from Keeping Books and Records at the CPO's Main Business Office

One of the Harmonization Rules that is generally applicable to all registered CPOs, not just Registered Fund CPOs, is an exemption from the requirement that a registered CPO must maintain all necessary books and records at its main business office. Any registered CPO (including a CPO that is relying on the partial exemption in Rule 4.7) may now maintain its books and records with the pool's administrator, distributor or custodian or a bank or registered broker or dealer (acting in such capacity with respect to the pool).[47]

In order to claim the exemption from the "main business office requirement" of Rule 4.23, a CPO must complete an electronic filing with the NFA in which it provides, and agrees to promptly correct, the following information: (i) the name, main business address and main business telephone number of each recordkeeper; (ii) the name and

telephone number of a contact person for each recordkeeper; and (iii) the books and records the recordkeeper will maintain.[48] In its filing with the NFA, a CPO also must represent that it will remain responsible for ensuring that its records are kept in accordance with Rule 1.31 and that it will produce its records for inspection by the CFTC at the CPO's main business office within 48 hours (or 72 hours if the CPO's records are kept outside of the U.S.).[49] The CPO also must file with the NFA a statement from the CPO's recordkeeper in which the recordkeeper agrees to keep records in accordance with Rule 1.31 and to make such records available for inspection by any representative of the CFTC, the NFA or the U.S. Department of Justice. Finally, the CPO must revise the pool's Disclosure Document (the Registered Fund's prospectus in the case of Substituted Compliance, or the offering memorandum, in the case of a 4.7 CPO) to disclose the location of the pool's books and records.

Reminder About Compliance with NFA Bylaws and Rules

Notwithstanding the CFTC's recognition and acceptance of Substituted Compliance, a Registered Fund CPO must

Table 1. Harmonization Rules: Quick Reference

Original Requirement	Harmonized Requirement
1. Update disclosure document every nine months.	Comply with current SEC annual update requirement.
2. Correct material inaccuracies in disclosure documents within 21 days of discovering defect.	Comply with current SEC updating requirements.
3. May not use a disclosure document until the NFA has reviewed and accepted.	Comply with current SEC review process. No need to file disclosure document with NFA for review or acceptance.
4. Must receive signed acknowledgment of receipt of disclosure document from prospective investors before accepting funds.	Comply with SEC disclosure document delivery requirements.
5. Not expressly permitted to use a summary prospectus.	May use summary prospectus that complies with SEC requirements.
6. Include CFTC prescribed legends in disclosure document.	Can use current SEC mandated legend provided a minor change is made to reference the CFTC.
7. Include CFTC-mandated risk disclosures in disclosure document.	Risk disclosure that satisfies SEC requirements deemed to satisfy CFTC requirement.
8. Disclose fees in "break-even table" (time needed to recoup fees and expenses applicable to investor in first year of investment).	Current SEC fee and expense disclosure deemed to satisfy CFTC requirement.
9. Include past performance of the CPO's other pools in a disclosure document of a RIC with less than three years operating history.	CPOs of RICs with less than three years of performance history required to provide performance of all accounts and pools that have substantially similar investment objectives, policies and strategies.
10. Disclose certain fees applicable to the RIC, including brokerage fees.	Compliance with SEC mandated fee and expense disclosures deemed sufficient.
11. CPOs of CFC subsidiaries of RICs required to prepare separate, CFTC-compliant disclosure documents (unless qualifying for an alternate exemption from CPO registration).	No special CFC disclosure required if RIC provides full disclosure of material information relating to CFC. CFC financial statements need not be separately filed with the NFA if consolidated with the RIC's financial statements.
12. Distribute directly to investors monthly account statements and annual reports.	RICs need not comply, provided their "current net asset value per share" is available to investors and it furnishes annual and semi-annual reports as required by SEC.
13. File CFTC-compliant annual reports with the NFA.	RIC CPOs must submit the RIC's semi-annual and annual reports to the NFA.
14. Keep books and records at the CPO's main office and make them available to investors.	RICs may continue to keep books and records at third-party service providers. The RIC's adviser is required to make a notice of filing with the CFTC and service provider must agree to maintain books and records in accordance with CFTC requirements.
15. Make the RIC's books and records available for inspection and copying by investors upon request.	RIC CPOs are exempted from this requirement.

comply with the NFA's rules and bylaws, some of which may not necessarily be consistent with the Harmonization Rules.[50] For example, NFA Compliance Rule 2-29(b)(5) prohibits the use of "promotional materials"[51] that use any numerical or statistical information about prior rates of return, unless such numerical or statistical information has been calculated in a manner consistent with specific provisions of CFTC Rule 4.25.[52] However, as discussed above, the Harmonization Rules exempt a Registered Fund CPO from the requirement to calculate past performance (either for the Registered Fund or for the Registered Fund CPO's other accounts and pools) in accordance with CFTC Rule 4.25.[53] Accordingly, Registered Fund CPOs are reminded to carefully consider the additional compliance obligations imposed by the NFA's rules and bylaws.

The foregoing article provides an overview of the impact the Harmonization Rules will have on investment advisers to Registered Funds that are required to register as commodity pool operators. A table summarizing these requirements is shown on page 46 for the convenience of the reader.

ENDNOTES

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1 Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators, 78 Fed. Reg. 52308 (Aug. 22, 2013) (hereinafter, "Adopting Release").

2 The CFTC Rules are available at http://www.cftc.gov/IndustryOversight/Intermediaries/CPOs/cpoctaexemptionsexclusions (last visited Nov. 28, 2013).

3 An investment adviser to a Registered Fund that can claim the Rule 4.5 exclusion need not be concerned with the Harmonization Rules because the adviser is excluded from the definition of "CPO." Similarly, if an investment adviser to a business development company ("BDC") has claimed the no-action relief in CFTC Staff Letter 12-40, *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-40.pdf, that adviser does not need to be concerned with the Harmonization Rules for its BDC because the adviser has been relieved from the requirement to register as a CPO. Similarly, an investment adviser to a Registered Fund that is a fund-of-funds that has claimed the no-action relief in CFTC Staff Letter 12-38, *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-38.pdf, does not need to be concerned with the Harmonization Rules for its registered fund-of-funds until 6 months following the issuance of revised guidance, either from the CFTC or from CFTC staff, concerning the application of the trading restrictions in Rule 4.5 to registered funds-of-funds.

4 United States Securities and Exchange Commission, Investment Management Unit, *Guidance Update*, *Disclosure and Compliance Matters for Investment Company Registrants That Invest in Commodity Interests*, No. 2013-05 (Aug. 2013), *available at* http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-05.pdf ("Guidance Update"). Unlike the Harmonization Rules, portions of the Guidance Update apply to all Registered Funds that invest in derivatives.

5 *See* Adopting Release, *supra* note 1 at 52311.

6 17 C.F.R. § 4.12(c)(1)(ii).

7 The NFA's electronic exemption filing system can be accessed at http://www.nfa.futures.org/NFA-electronic-filings/exemptions.HTML (last visited Nov. 28, 2013).

8 17 C.F.R. § 4.12(d)(1)(v).

9 *See* 17 C.F.R. § 4.12(d)(2)(i); 17 C.F.R. § 1.3(yy) ("Commodity interest" is the defined term for the universe of CFTC-regulated products.).

10 *See* 17 C.F.R. § 4.12(d)(4)(i).

11 17 C.F.R. § 4.12(d)(2)(ii).

12 17 C.F.R. § 4.12(c)(3)(i)(A) and (B).

13 *See* Adopting Release, *supra* note 1 at 52314

The Commission has determined to deem CPOs of RICs compliant with the provisions of §§ 4.24 and 4.25, provided that they are in compliance with the disclosure requirements of the Securities Act, the '40 Act, and the applicable SEC RIC Rules. By deeming such CPOs compliant, the ability to use a statutory prospectus and/or Summary Prospectus in a format recognizable to both funds and their participants has not been disturbed. For ease of reference, we refer to a Registered Fund's disclosure document as its "prospectus" rather than the more cumbersome "registration statement," unless the context otherwise requires us to be more specific. When we refer to a Registered Fund's "prospectus," we also include any summary prospectus it may use and its Statement of Additional Information.

14 17 C.F.R. § 4.26(d).

15 17 C.F.R. § 4.12(c)(3)(i); *see* Adopting Release, *supra* note 1 at 52313.

16 17 C.F.R. § 4.12(c)(3).

17 Adopting Release, *supra* note 1 at 52313.

18 *Id*.

19 *Id*.

20 *Id*. Notably, in the same Adopting Release the CFTC expressly declined to amend Rule 4.26 to allow all CPOs to use a Part 4 Disclosure Document for up to 16 months. *See id.* at 52312-13.

21 17 C.F.R. § 4.21(b).

22 *See* 17 C.F.R. § 4.24(d)(5); *see also* 17 C.F.R. § 4.10(j) (A "break-even point" is defined 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.").

23 This description of fees must include any

(i) Management fees;

(ii) Brokerage fees and commissions, including interest income paid to futures commission

merchants, and any fees incurred to maintain an open position in retail forex transactions;

(iii) Fees and commissions paid in connection with trading advice provided to the pool;

(iv) Fees and expenses incurred within investments in investee pools, investee funds and other collective investment vehicles, which fees and expenses must be disclosed separately for each investment tier;

(v) Incentive fees;

(vi) Any allocation to the commodity pool operator, or any agreement or understanding which provides the commodity pool operator with the right to receive a distribution, where such allocation or distribution is greater than a pro rata share of the pool's profits based on the percentage of capital contributions made by the commodity pool operator;

(vii) Commissions or other benefits, including trailing commissions paid or that may be paid or accrue, directly or indirectly, to any person in connection with the solicitation of participations in the pool;

(viii) Professional and general administrative fees and expenses, including legal and accounting fees and office supplies expenses;

(ix) Organizational and offering expenses;

(x) Clearance fees and fees paid to national exchanges and self-regulatory organizations; and

(xi) any other direct or indirect cost.

[17] C.F.R. § 4.24(i)(2).

[24] 17 C.F.R. § 230.481(b)(1).

[25] Adopting Release, *supra* note 1 at 52315; *see* 17 C.F.R. §230.481(b)(i).

[26] 17 C.F.R. § 4.25(c).

[27] 17 C.F.R. § 4.12(c)(3)(i)(A).

[28] Adopting Release, *supra* note 1 at 52318.

[29] *See* ITT Hartford Mutual Funds, SEC No-Action Letter, 1997 WL 50054 (pub. avail. Feb. 7, 1997); Nicholas-Applegate Mutual Funds, SEC No-Action Letter, 1997 WL 50052 (pub. avail. Aug 6, 1996).

[30] The six existing investment companies could not be publicly offered because they were funding media for ITT Hartford's variable insurance products. According to the no-action request letter from ITT Hartford's outside counsel, but for the tax laws preventing the six existing investment companies from being directly offered to the public, ITT Hartford would not have created the six publicly offered versions of the existing funds.

[31] *See* Growth Stock Outlook Trust, Inc., SEC No-Action Letter, 1986 WL 65418 (pub. avail. Apr. 15, 1986).

[32] An alternative, and less plausible interpretation, is that the CFTC expects the past performance of the Registered Fund CPO's other accounts and pools to be presented in accordance with the requirements of Rule 4.25(c). This interpretation seems to contradict the plain language of Rule 4.12(c)(3)(i), which specifically exempts a Registered Fund CPO from the requirements of Rule 4.25, and would produce a bizarre result in that the presentation of the past performance of the Registered Fund itself would differ materially from the presentation of the past performance of the Registered Fund CPO's other accounts and pools.

[33] Adopting Release, *supra* note 1 at 52319-20.

[34] *Id*. at 52319.

[35] *Id*.

[36] 17 C.F.R. § 4.21(a)(2).

[37] 17 C.F.R. §§ 4.12(c)(3)(i)(B), 4.12(d)(2)(ii)(B).

[38] The Adopting Release does not contain any discussion about the consequences of a technical violation of the Securities Laws, though presumably the CFTC would not intend for such technical violations of the Securities Laws to compromise the eligibility of a Registered Fund CPO to qualify for the exemption in Rule 4.12(c)(3).

[39] *See generally* Adopting Release, *supra* note 1. The civil monetary penalty resulting from a violation of Part 4 carries a maximum penalty of $140,000 (or triple the monetary gain of the violation) and could give rise to liability for actual damages in a private action arising under section 22 of the Commodity Exchange Act. *See* 7 U.S.C. § 25; see also 7 U.S.C. § 6(c) and (d).

[40] 17 C.F.R. §§ 4.22(a) and (b).

[41] 17 C.F.R. § 4.12(c)(3)(ii); Adopting Release, *supra* note 1 at 52311. It should be noted that the requirement to file a Registered Fund's annual financial statements is not in any rule, but instead is discussed in the Adopting Release.

[42] Adopting Release, *supra* note 1 at 52320.

[43] The Securities Laws do not mandate the frequency of calculation and dissemination of net asset values by closed-end Registered Funds. It is possible for a closed-end Registered Fund to calculate net asset value only twice a year in its annual and semi-annual financial statements. However, many closed-end Registered Funds calculate and publish net asset value more frequently (e.g., monthly, weekly or daily).

[44] *Id*.at 52320.

[45] *Id*.

[46] *Id.* at 52319.

[47] *See* 17 C.F.R. § 4.7(b)(4) and (5); 17 C.F.R. § 4.23(a)(4) and (c).

[48] 17 C.F.R. §§ 4.7(b)(5)(i) and 4.23(c)(1).

[49] 17 C.F.R. § 4.23(c)(1)(iv)(C).

[50] The NFA Compliance Rules are available at http://www.nfa.futures.org/nfamanual/NFAManual-TOC.aspx?Section=4 (last visited Nov. 29, 2013) (hereinafter, "NFA Compliance Rule").

[51] Rule 2-29 is available at http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=RULE%202-29&Section=4 (last visited Nov. 29, 2013)."Promotional material" is broadly defined as "any other written material disseminated or directed to the public for the purpose of soliciting a futures account, agreement or transaction." NFA Compliance Rule 2-29(i)(1)(iii).

[52] Such past performance must be calculated "in a manner consistent with CFTC Regulation 4.25(a)(7) for commodity pools and with CFTC Regulation 4.35(a)(6), as modified by NFA Compliance Rule 2-34(a), for . . . separate accounts." NFA Compliance Rule 2-29(b)(5)(ii).

[53] *See* supra note 33.