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What the CFTC Rule Revisions Mean for Registered Investment Companies and Their Investment Advisers

By Michael Philipp, Sean Graber, Laura Flores and John O'Brien

Until recently, advisers to registered investment companies[1] that invested in commodities and commodity-linked derivatives could expect to be regulated primarily by the US Securities and Exchange Commission (SEC). They generally were able to avail themselves of an exemption or fit within an exclusion that permitted them to avoid compliance with the bulk of the Commodity Futures Trading Commission's (CFTC) regulatory regime. That division of regulatory oversight ended on April 24, 2012.

On February 8, 2012, the CFTC adopted new rules and amended existing rules[2] that now require commodity pool operator (CPO) registration by investment advisers operating registered investment companies that conduct more than a *de minimis* amount of speculative trading in futures, commodity options, swaps and other commodity interests. This new regulatory regime overlaps with existing SEC regulations for mutual funds, resulting in a dual framework of regulation that will lead to new compliance challenges for mutual funds and their advisers and other service providers.

Although the CFTC simultaneously effected other rule changes that affect advisers to private funds that invest in commodities and commodity-linked derivatives, this article focuses on the modifications to CFTC

Michael Philipp is a Partner and Sean Graber, Laura Flores and Jack O'Brien are Associates in Morgan, Lewis & Bockius LLP's Investment Management Practice Group. Mr. Philipp is in Morgan Lewis's Chicago office, Ms. Flores in its Washington, DC office and Messrs. Graber and O'Brien in its Philadelphia office. The authors would also like to acknowledge the following colleagues at Morgan Lewis who assisted with the article: Tim Levin, Michael Piracci and Dana Westfall.

Rule 4.5. Rule 4.5 has been relied on by most mutual funds and their advisers as a definitional exclusion from being deemed a CPO under the Commodity Exchange Act (CEA). Further, this article is designed to inform mutual funds and their advisers of how the recent changes to the CFTC rules will affect them—including the proposed CFTC-SEC harmonization rules—and suggest how they might plan for compliance. Advisers to mutual funds with a Rule 4.5 notice on file with the CFTC prior to April 24, 2012 will have until at least December 2012 to register as a CPO or satisfy the *de minimis* trading thresholds.

Background

The CFTC, which regulates commodity futures and swaps in the United States, administers a comprehensive regulatory structure that governs accounts, agreements (including options), and transactions involving contracts of sale of a commodity for future delivery (futures), swaps, as well as the entities involved in managing or advising funds that invest in commodity interests (commodity pools). Generally speaking, the CFTC has jurisdiction over all futures contracts, options on futures contracts, and swap contracts on "commodities," as defined in the CEA. The CEA requires that futures contracts and options on futures contracts be traded on an exchange (designated contract market) registered with and regulated by the CFTC. Swaps that are determined by the CFTC to be subject to a mandatory clearing requirement are required to be traded on a designated contract market or swap execution facility, and clearing through a derivatives clearing organization. Although the term "commodity" is generally thought of as applying to physical raw materials, such as agricultural items (for example, wheat, cotton, rice, livestock and corn), metals (for example, copper, silver and gold) and energy resources (for example, crude oil, natural gas and heating oil), the scope of the CEA and the authority of the CFTC extend not only to contracts on these raw materials but also to interest rates, currencies, broad-based stock indices, and other tangible and intangible goods, and options on the foregoing. Until the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), many "over-the-counter" transactions (that is, swaps) were exempted or excluded from most of the CFTC's jurisdiction. The Dodd-Frank Act expanded the CFTC's jurisdiction, particularly with respect to swaps and the CFTC's antifraud provisions. The CEA and the authority of the CFTC, however, do not extend to regulation of securities (except for security futures) or to commercial forward contracts that are settled by physical delivery.

The CEA defines the term "commodity pool" as any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests.[3] CPOs have been subject to CFTC regulation since the CFTC was created in 1974. As defined in Section 1a(11) of the CEA, a CPO is any person engaged in the business of an investment trust or similar form of enterprise who receives funds from others for the purpose of trading commodity interests.[4] Because investors in commodity pools are not obligated to respond to margin calls or personally settle contracts and are generally not subject to personal liability, commodity pools have become an attractive investment vehicle. In general, a CPO is the person or entity that organizes and promotes a commodity pool**,** has the authority to hire and fire the commodity pool's commodity trading advisors (CTAs), and selects the commodity pool's futures commission merchant.[5] Because the sale of an investment in a collective investment vehicle is the sale of a security, interests in commodity pools, unless they qualify for an exemption, generally are subject to the provisions of the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act), whereas CPOs themselves, unless exempt or excluded from the definition of CPO, are required to register with the CFTC and become members of the National Futures Association (NFA).

The scope of regulation of CPOs has varied over time. CFTC Rule 4.5 provides an exclusion from the definition of CPO for persons operating entities regulated as registered investment companies, banks, benefit plans, and insurance companies that meet certain qualifications.[6] Prior to August 2003, any of these regulated persons who claimed the Rule 4.5 exclusion were required to represent to the

CFTC that any commodity futures or options contracts they entered into were for bona fide hedging purposes[7] and that the aggregate initial margin and/or premiums for positions that did not meet the bona fide hedging criteria did not exceed five percent of the liquidating value of a qualifying entity's portfolio (after taking into account unrealized profits and losses). Rule 4.5 further required that investments in these entities not be marketed as participation in a commodity pool or otherwise as a vehicle for trading commodity futures or options. Prior to August 2003, most mutual funds chose to comply with these trading and marketing restrictions in order to avoid registration of the fund adviser as a CPO.

In August 2003, as part of a larger overhaul of its regulation of CPOs and CTAs and based partly on the fact that such regulated entities were already subject to extensive regulation by other regulators, the CFTC eliminated the trading and marketing restrictions set forth in Rule 4.5.[8] After these 2003 amendments, registered investment companies were effectively unlimited as to the amount of futures trading they could undertake, so long as such investments otherwise complied with the regulatory framework of the Investment Company Act of 1940 (1940 Act) (for example, Section 18 coverage requirements).[9]

The unwinding of the leverage bubble in 2008, and the price spikes in oil and agricultural commodities in the summer of 2008, plus the advent of passive long-only investment strategies in commodity interests by a number of investment companies seeking price exposure to commodities refocused legislative and regulatory attention on commodity and derivative products. Among other regulatory actions, the SEC commenced a review of the use of derivatives by registered investment companies[10] and the NFA petitioned the CFTC to amend Rule 4.5 for the purpose of restoring the operating restrictions on mutual funds that were in effect prior to 2003.[11] In response to the market disruptions of 2008, the Dodd-Frank Act was enacted, which tasked the CFTC with defining and regulating swaps and other derivatives, including requiring most plain vanilla standardized swaps to be exchange traded, cleared, and reported. The Dodd-Frank Act also expanded the definition of commodity interests, which had the effect of including persons engaging in swap transactions within the definition of CPO set forth in the CEA. In January 2011, the CFTC proposed to return Rule 4.5 largely to its pre-2003 form.

As amended on February 8, 2012, Rule 4.5 was returned to its pre-2003 state with respect to the requirements for registered investment companies (but not for the other types of regulated entities), but with the addition of an alternative test for "*de minimis*" investments.[12] The CFTC noted in the Adopting Release, as it had in the Proposing Release, that it was concerned that funds were "offering de facto commodity pools" and should be subject to CFTC oversight to "ensure consistent treatment of CPOs regardless of their status with respect to other regulators."[13] In particular, the CFTC expressed concern about mutual funds' increased use of derivatives because, in the CFTC's view, such increased trading activity may not have been appropriately addressed by the existing regulatory structure, including risk management and recordkeeping and reporting provisions.[14]

Trading Thresholds for Remaining Exempt from Registration

To continue to rely on Rule 4.5, a registered investment company will have to limit its investments in commodity futures, commodity options contracts and swaps to below one of two thresholds. One of the thresholds requires that the fund's aggregate initial margin and premiums posted for its non-bona fide hedging trading in these instruments must not exceed five percent of the liquidating value of its portfolio (after taking into account unrealized profits and losses and excluding the in-the-money amount of an option at the time of purchase).[15] As an alternative, the fund may limit the aggregate net notional value[16] of its commodity futures, commodity options contracts, and swaps positions not used solely for bona fide hedging purposes to no more than 100 percent of the liquidation value of its portfolio determined at the time the most recent position was established (after taking into account unrealized profits and losses).[17] This alternative *de minimis* threshold, which was added by the CFTC in response to concerns from commenters that initial margin for certain commodity interest products may not otherwise permit compliance with the five percent threshold, allows a fund to enter into non-bona fide hedging transactions in these instruments having a net notional value equal to up to 100 percent of the fund's net asset value (NAV).[18] In discussing its rationale for the percentage limitations included in the two trading thresholds, the CFTC stated that it views commodity interest trading in excess of these two trading thresholds as evidencing "a significant exposure to the derivatives markets" that "should subject an entity to the [CFTC's] oversight."[19] Despite requests from commenters to the contrary, a fund must include its use of broad-based stock index futures, security futures, and financial futures contracts in determining whether the fund meets the *de minimis* thresholds for exemption. In addition, the CFTC expressly rejected a request to exclude from the two trading thresholds funds that engage in a passive strategy of index tracking.[20] Had the CFTC adopted this passive investment carve-out, advisers solely to index-tracking exchange traded funds (ETFs) could have been able to avoid CPO registration.[21]

One uncertainty in calculating the *de minimis* thresholds is the fact that the Dodd-Frank Act entitles the US Department of the Treasury (Treasury) to make a determination that certain currency-based derivatives are not "swaps" for purposes of the CEA. In April 2011, the Treasury issued a proposed determination that would exempt foreign exchange swaps and foreign exchange forwards from the definition of "swaps" (Treasury Exemption).[22] As a result, deliverable foreign exchange swaps and foreign exchange forwards that are physically settled would not be "swaps" and would not be counted toward the *de minimis* threshold for purposes of the Rule 4.5 exclusions. The Treasury Exemption would not exclude foreign exchange options, non-deliverable currency swaps and non-deliverable forwards from the definition of "swaps," so these instruments would remain subject to the Rule 4.5 trading thresholds. Although these carve-outs, if adopted by the Treasury, could be beneficial for some funds with respect to complying with the trading thresholds, the swaps and forwards must be deliverable in order to be carved out. In most cases, mutual funds and ETFs use non-deliverable contracts to reduce the amount of coverage required for such contracts in light of the SEC guidance regarding senior securities under Section 18 of the 1940 Act. Additionally, the currency in many emerging markets may only be traded through non-deliverable instruments.

Many industry participants are uncertain as to whether the 100 percent net notional test is a reliable means to measure an entity's exposure in the markets and the risks associated with such exposures.[23] Further, there is a risk that this test may disproportionately affect certain types of funds because certain derivatives strategies and instruments require a much higher notional value to have the desired result. For example, the implementation of an interest rate strategy in a bond fund would generally require the use of futures with a much higher notional value than if the fund was trying to gain exposure to the S&P 500 Index through the use of futures.[24] Accordingly, funds that use strategies or instruments that require high notional values may be disproportionately affected by the 100 percent net notional test notwithstanding the fact that such funds may not pose a greater risk to the markets.

With respect to the five percent trading threshold, many in the industry feel that a five percent threshold does not reflect the realities of the current market in light of the fact that current margin levels for a number of derivative instruments in which registered investment companies invest now exceed five percent of contract value.[25] As a result, funds may need to reduce their use of instruments with higher margin requirements for non-hedging purposes if they want to stay within the five percent trading threshold exemption under Rule 4.5.

These trading thresholds could also have the unintended consequence of causing funds to move away from the established futures markets and invest more heavily in structured notes, which are not subject to the trading thresholds, but which raise their own set of issues (for example, increased investment cost, a limited number of issuers, and a lack of liquidity and price transparency).

Bona Fide Hedging Excluded from the Trading Thresholds

As discussed above, a fund's use of commodity futures, commodity options contracts, or swaps solely for "bona fide hedging purposes," is carved out of the calculation of the two trading threshold exemptions under Rule 4.5.[26] Although this may initially seem like a significant exception to the threshold calculations, it is, in actuality, of very little practical use because of the narrow definition of "bona fide hedging." Under the CEA definitions, "bona fide hedges" must effectively represent a substitute for transactions in the cash or spot market, and do not extend to those types of risk mitigation for which derivatives are commonly used by mutual funds to "hedge" certain exposures. This is exemplified by the fact that, in the Adopting Release, the CFTC warned that market participants should not construe the definition of "bona fide hedging" to permit a risk management exemption for purposes of determining compliance with the trading thresholds in Rule 4.5.[27] The CFTC's declaration against risk mitigation was in direct contrast to requests from commenters that sought to convince the CFTC to expand "bona fide hedging" to include positions taken by mutual funds to offset risk in their securities or bond market positions or for cash equitization.

In October 2011, the CFTC created a new definition of bona fide hedging for "referenced contracts" pursuant to Section 737 of the Dodd-Frank Act.[28] The "referenced contracts," which include futures and options contracts on 28 physical commodities (for example, agriculture, energy, and metals), as well as swaps that are economically equivalent to such contracts, are now subject to the definition of a bona fide hedging transaction contained in CFTC Rule 151.5. "Excluded commodities" (for example, interest rates, exchange rates, currencies and debt or equity instruments)[29] are still subject to the definition of "bona fide hedging" contained in CFTC Rule 1.3(z)(1). The new Rule 151.5 definition generally follows the Rule 1.3(z)(1) definition, with two significant differences. First, the new statutory definition recognizes a position in a futures contract established to reduce the risks of a swap position as a bona fide hedge, provided that either (i) the counterparty to such swap transaction would have qualified for a bona fide hedging transaction exemption, (that is, the "pass-through" of the bona fides of one swap counterparty to another (such swaps may be termed "pass-through swaps")); or (ii) the swap meets the requirements of a bona fide hedging transaction. Second, a bona fide hedging transaction or position must represent a substitute for a physical market transaction.[30]

In light of the foregoing, in order to classify a position as a bona fide hedge for purposes of Rule 4.5, a fund should undertake a careful analysis of the type of instrument in question, the purpose of the position, the position being hedged and the application of the relevant definition in either CFTC Rule 1.3(z)(1) or 151.5.

Marketing Restrictions for Remaining Exempt from Registration

Even if a fund can fit within either of the two trading thresholds so that the fund's adviser can fit the exclusion from the CPO definition under Rule 4.5, the adviser would be unable to rely on Rule 4.5 if the fund was marketed "as a vehicle for trading in the commodity futures, commodity options or swaps markets."[31] In the Adopting Release, the CFTC included a list of factors that it would consider in determining whether a fund was being marketed in violation of Rule 4.5, which included:

- The fund's name;
- Whether the fund's primary investment objective is tied to a commodity index;
- Whether the fund uses a controlled foreign corporation (CFC) for derivatives trading;[32]
- Whether the fund's marketing materials (including the fund's prospectus and/or

disclosure document) refer to the benefits of derivatives or make comparisons to a derivatives index;

- Whether the fund has a net short speculative exposure to any commodity through derivatives investment during the course of its normal trading activities; and

- Whether derivatives transactions will be the primary source of the fund's gains and losses.[33]

The CFTC indicated that it will give more weight to the final factor in the list when determining whether a mutual fund is operating as a *de facto* commodity pool. The CFTC indicated that violations will be determined on a case-by-case basis, depending on the particular facts and circumstances.

As noted by many industry commentators, the marketing restriction under Rule 4.5, as drafted, introduces a level of uncertainty and an opportunity for second-guessing as to a fund's proper status under Rule 4.5. If the CFTC takes a broad interpretation of the marketing restriction, such restriction could effectively eliminate the benefit of limiting trading to meet the *de minimis* thresholds under Rule 4.5. The only comfort provided by the CFTC thus far has been the following statement included in the Adopting Release: "[The CFTC] will not consider the mere disclosure to investors or potential investors that the registered investment company may engage in derivatives trading incidental to its main investment strategy and the risks associated therewith as being violative of the marketing restriction."[34] Accordingly, a general statement that the fund may invest in futures and swaps should not violate the marketing restriction set forth in Rule 4.5.

Application of Rule 4.5 to a Mutual Fund's Use of a Controlled Foreign Corporation (CFC)

A fund must derive at least 90 percent of its gross income from certain qualifying sources of income in order to qualify as a regulated investment company under the Internal Revenue Code of 1986 (the Code). In 2005, the Internal Revenue Service (IRS) issued a revenue ruling that concluded that income and gains from certain commodity-linked derivatives are not "qualifying income" under Subchapter M of the Code. As a result, a fund's ability to invest directly in commodity-linked swaps as part of its investment strategy is limited by the requirement that it receive no more than 10 percent of its gross income from such investments. Beginning in 2006, the IRS has issued private letter rulings to certain funds indicating that the income derived from a fund's investments in a CFC will constitute "qualifying income" to the fund, even if the CFC itself owns commodity-linked swaps. Accordingly, many funds have established CFCs through which the funds obtain their exposure to commodities that do not produce "qualifying income" under Subchapter M of the Code. The IRS, however, has stopped issuing such rulings. CFCs are typically structured as offshore vehicles that are wholly-owned by the fund. A fund generally is not permitted to invest more than 25 percent of its assets in any one issuer under Subchapter M diversification requirements. As a result, funds are able to only invest 25 percent of their total assets in a CFC.

In the Adopting Release, the CFTC addressed the application of Rule 4.5 with respect to mutual funds investing in commodities through a CFC.[35] Although the CFTC indicated that it was not opposed to the continued use of CFCs by funds, the CFTC made clear that a CFC that is engaging in commodity trading is itself a commodity pool and, accordingly, persons operating a CFC must register as CPOs unless they qualify for an exemption "on their own merits."[36] The CFTC stated that a CFC must be assessed on its own characteristics and that a CFC is not entitled to exclusion under Rule 4.5 because its parent company is a mutual fund that may be entitled to exclusion.[37]

As a result of the above, it is likely that most operators of mutual fund CFCs used for commodity investing will be required to register as CPOs, although, in most instances, such persons will be subject to a reduced compliance burden with respect to the CFC.[38] It is too early to predict whether the CFTC registration rules will negatively affect mutual funds' use of CFCs to obtain commodities exposure. The decision to discontinue the use of CFCs will likely be made by each investment adviser individually after evaluating the overall impact of Rule 4.5 with respect to all mutual funds and accounts advised by such adviser. One possible set of beneficiaries of the new CFTC rules are the issuers of commodity-linked notes. As a possible alternative to the use of a CFC, funds may seek to increase their use of IRS-approved commodity-linked notes in an attempt to gain commodities exposure and avoid CPO registration requirements.

On a related topic, in the Adopting Release the CFTC discussed certain unique issues surrounding Rule 4.5 related to funds of funds. Relying on the fact that the statutory definition of "commodity pool" does not distinguish between direct and indirect investments in commodity interests, the CFTC stated that a fund that invests in an unaffiliated commodity pool is itself a commodity pool for purposes of the CEA and the CFTC's rules.[39] The CFTC further noted that allowing an exemption for indirect investments in commodity interests would create an incentive for entities to avoid direct investments in commodity interests to, in turn, avoid registration as CPOs. This guidance may cause mutual funds that currently invest in other mutual funds or ETFs (rather than CFCs) in order to gain exposure to the commodities markets to reevaluate this practice to determine whether the practice has implications under Rule 4.5.

Who Will Register?

The issuance of the Proposing Release sparked considerable discussion in the fund industry regarding the appropriate entity that would be required to register as a CPO if the mutual fund could not qualify for exclusion under Rule 4.5. Many in the industry were concerned that a registered investment company's board of trustees or directors would be required to register. Accordingly, many fund industry participants urged the CFTC to make clear that the investment adviser to the fund would be the person required to register as the CPO. The CFTC recognized that requiring trustees or directors to register as CPOs "would raise operational concerns for the registered investment company as it would result in piercing the limitation on liability for actions undertaken in the capacity as director."[40] As a result, the CFTC concluded that the investment adviser for the fund is the entity required to register as the CPO.[41] Notwithstanding this fact, fund boards will want to discuss the implications of being subject to the CFTC regulatory regime with their D&O/E&O and fidelity bond insurance providers. Further, fund boards may want to have their counsel review (i) the indemnification provisions in their governing documents to identify any possible gaps with respect to indemnifiable acts, and (ii) fund service provider agreements to identify any possible gaps in services, including compliance monitoring, required to be performed in light of the new CFTC regulations.

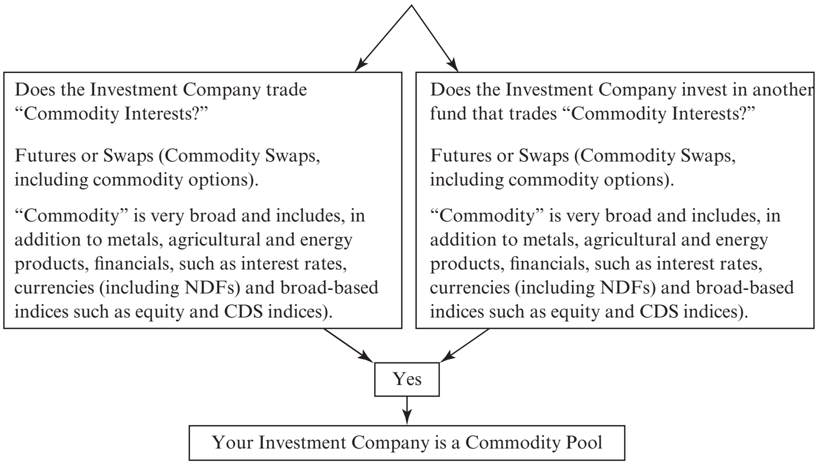
The CFTC did not specifically address the registration implications of advisers who act as managers-of-managers for their funds (that is, advisers who hire and oversee sub-advisers who, in turn, manage the day-to-day investment of the fund's portfolio). In this situation, we would expect the adviser to be the appropriate entity to register as the CPO for the fund and not the individual sub-advisers. The sub-advisers, however, will likely be required to register as CTAs.

The above "decision tree" may provide useful guidance to funds when determining whether registration under Rule 4.5 is required.

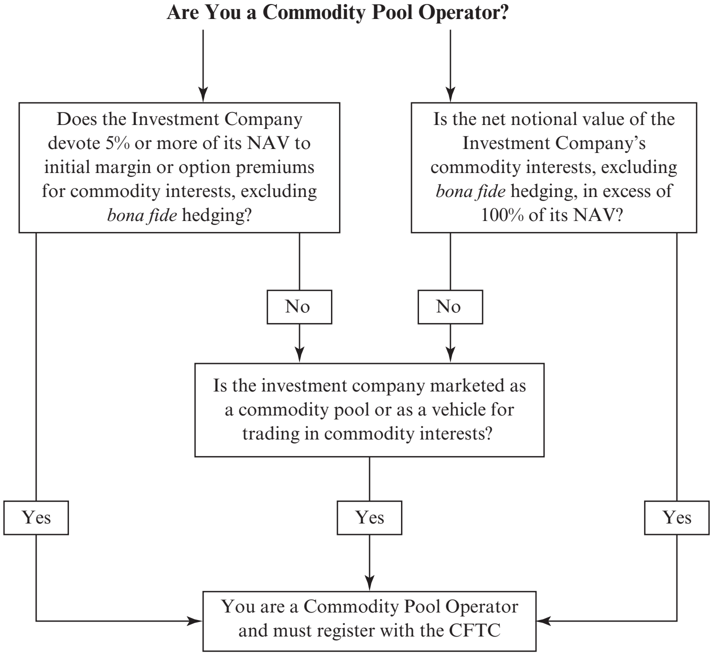
Registration Deadline and Annual Notice Filing Requirement

If a mutual fund has not filed a Rule 4.5 notice with the NFA prior to April 24, 2012, then the investment adviser to such fund is required to register as a CPO at that date unless the adviser is entitled to an exclusion under amended Rule 4.5. With respect to mutual funds that have filed Rule 4.5 notices with the NFA prior to April 24, 2012, investment advisers to such funds that are required to register as CPOs as a result of changes in Rule 4.5 must become registered by the later of December 31, 2012 or 60 days after the

Is your Investment Company a Commodity Pool?



Are You a Commodity Pool Operator?



effective date of the final rulemaking by the CFTC defining the term "swap" and establishing margin requirements for swap positions.[42] The CFTC expressly rejected requests from commenters that would grandfather existing fund advisers out of the new regulatory framework. Once an investment adviser is registered as a CPO for a registered investment company, it will not be required to comply with the CFTC's recordkeeping, reporting, and disclosure requirements until 60 days after the adoption of final rules implementing the CFTC harmonization rules discussed below.

Previously, Rule 4.5 required persons claiming relief from registration with the CFTC to electronically file with the NFA a notice claiming such exemption only once at the inception of the fund. As amended, however, Rule 4.5 requires that on an annual basis, in order to retain eligibility for the exemption, persons who are still eligible for relief under Rule 4.5 must affirm the accuracy of their original notice of exemption, withdraw such exemption if they cease to conduct activities requiring registration or exemption from registration, or withdraw the exemption and apply for registration within 60 days of the calendar year end.

Implications of Registration as a CPO

It is expected that the revisions to CFTC Rule 4.5 will cause a significant number of investment advisers to register as CPOs with respect to certain of the mutual funds they manage. Funds that use commodities for non-bona fide hedging purposes above a *de minimis* amount, funds that use CFCs, and funds that provide significant commodities exposure and market themselves as such (which include many ETFs) are directly in the cross-hairs of the new regulations. Investment advisers to these funds should begin to review the CPO registration process in an effort to become familiar with the process and the consequences of registration.

Registration as a CPO is a relatively involved process and typically takes from six to eight weeks to complete. Registration involves submission of Form 7-R for the CPO and Forms 8-R for all natural person principals and for all associated persons (APs), along with fingerprints for such principals and APs, as well as proof that each AP passed the required proficiency exams (generally the Series 3).[43] At least one principal will be required to be registered as an AP.

Advisers registering as CPOs with respect to their funds will be subject to additional potential regulatory and shareholder liability. Registered CPOs are subject to punitive or remedial action from the CFTC and could have their CFTC registration revoked or denied for violations of the CEA or CFTC regulations. Investors in a fund that qualifies as a commodity pool under Rule 4.5 will have access to the CFTC's reparations program and NFA's arbitration program.[44] Further, registered CPOs will have liability for violations of the CEA by the CPO *and* the fund. In this regard, advisers should review whether CPO registration will cause the adviser to be primarily liable for the fund's disclosure documents filed with the CFTC or whether the recent US Supreme Court decision in *Janus Capital Group, Inc. v. First Derivative Traders* will continue to protect the adviser from primary liability.[45] Further, to the extent there is a risk that the CFTC will hold the adviser of the fund (that is, the registered CPO of the fund) responsible for violations of the CEA and CFTC rules by the fund that are caused by other fund service providers (for example, sub-advisers, administrators, distributors or custodians), the adviser should seek to enter into agreements with such service providers that provide the adviser with indemnification and contribution for such acts. The extent to which the remedies provided to participants in commodity pools under the CEA and CFTC rules differ from those provided to fund shareholders under the 1940 Act, the 1933 Act, and the 1934 Act should also be analyzed by both advisers and funds. Finally, investment advisers registering as CPOs with respect to their mutual funds should review, among other things, their investment advisory agreements with their funds and their directors' and officers' (D&O) insurance policies to determine whether changes are appropriate in light of this additional layer of liability.[46]

Advisers that will be required to register as CPOs with respect to registered investment companies will also have to file Form CPO-PQR with the NFA, which is a commodity pool's quarterly report.[47] Form CPO-PQR requires disclosure of extensive information about each pool operated by a CPO, the CPO itself, and third-party service providers. CPOs will also be required to provide statements about changes in the pool's assets under management, monthly rates of return, and subscription and redemption activity. Extensive financial and risk information must also be disclosed on a quarterly basis. Depending on the size of assets under management by the CPO, reporting requirements may increase or decrease. Also, for those advisers that also manage private funds, Form CPO-PQR is in addition to (and not instead of) any reporting requirements imposed by Form PF. However, the CFTC indicated in the Adopting Release that it intends to amend Rule 4.27 so that dual registrants filing Form PF would not need to file Schedules B and C to Form CPO-PQR.[48] Further complicating compliance for those advisers, assets under management must be calculated in different ways for Form PF and Form CPO-PQR and the forms are required to be filed on different timelines. As a result, it is expected that Form CPO-PQR will be a significant undertaking for advisers' fund accounting, administration and compliance departments, particularly considering the overlap with other recently enacted regulatory reporting requirements such as Form PF and amendments to Form ADV.[49]

Harmonization of SEC and CFTC Regulations

Parallel to the release adopting amendments to Rule 4.5, the CFTC on February 9, 2012 also proposed rulemaking intended to harmonize certain CFTC- and SEC-imposed compliance requirements in an effort to mitigate the burden on mutual funds with respect to complying with the two similar, but separate, compliance regimes (the Proposed Rules).[50] The Proposed Rules address each of the harmonization concerns raised by the NFA in its comment letter to the CFTC[51] and focus on the harmonization of certain requirements in three key areas: disclosure documents, periodic reports, and recordkeeping. Advisers to funds that will be required to register as CPOs should keep a close eye on the development of the Proposed Rules. Comments on the Proposed Rules were due to the CFTC by April 24.[52]

Harmonization of Disclosure Documents

Delivery Requirement. CFTC Rule 4.21 currently requires a CPO to deliver a disclosure document prepared in accordance with CFTC Rules 4.24 and 4.25 to each prospective investor in the pool by no later than the time it delivers to the prospective investor a subscription agreement for the pool. CFTC Rule 4.21 further requires that a CPO not accept or receive funds, securities, or other property from a prospective investor unless the CPO first receives a signed and dated acknowledgement from the prospective investor stating that he or she received the disclosure document.

In response to comments that these requirements are at odds with prospectus delivery requirements applicable to registered investment companies under Section 5(b)(2) of the 1933 Act and would generally preclude fund distribution through certain platforms, the CFTC proposes to amend Rule 4.12(c) to permit the CPO of any pool whose interests are offered and sold pursuant to an effective registration statement under the 1933 Act to claim relief from, among other requirements, the disclosure document delivery and acknowledgement requirements under Rule 4.21. Currently, CFTC Rule 4.12(c), which was adopted to provide compliance relief to ETFs, is available only to CPOs of pools whose interests are both offered and sold pursuant to an effective registration statement under the 1933 Act and listed for trading on a national securities exchange registered as such under the 1934 Act. However, in the Harmonization Release, the CFTC noted that "there is no useful distinction between publicly offered pools whose units are listed for trading on a national securities exchange, and those which are not."[53]

The relief provided by Rule 4.12(c) is subject to certain conditions, including that the CPO make the disclosure document readily accessible on its website, which would effectively require any mutual fund complexes without public websites to create websites in order to avoid costly delivery requirements. Further, Rule 4.12(c) would require funds to inform shareholders of the address of this website and instruct fund intermediaries to do the same. In addition, to rely on the exemptive relief provided by Rule 4.12(c), a registered investment company and its CPO must file a notice of claim for exemption with the NFA consistent with the requirements of Rule 4.12(d).

Break-Even Point and Fees and Expenses Disclosure. Rather than prepare both a prospectus and an SAI to be filed with the SEC and a separate disclosure document to be filed with the NFA, the Proposed Rules would permit registered investment companies no longer able to rely on Rule 4.5 to include CFTC-required disclosures in their Form N-1A filings.[54] The Proposed Rules contemplate that registered open-end investment companies would present in their prospectus, following the summary section, a tabular presentation of the calculation of the registered investment company's break-even point required by CFTC Rule 4.24. The break-even analysis is an illustration of the trading profit that the fund must realize during the first year after a shareholder's investment such that the shareholder would recoup his or her initial investment, which is calculated both in terms of dollars and a percentage of the minimum initial investment. The CFTC noted in the Harmonization Release that it views this disclosure as "necessary" in that "it mandates a greater level of detail regarding brokerage fees and does not assume a specific rate of return."[55]

The Proposed Rules also indicate that the registered investment company must disclose all fees and expenses required to be disclosed pursuant to CFTC Rule 4.24(i). Certain of the fees required by Rule 4.24(i) are not currently required to be presented separately in a registered investment company's fee table pursuant to Item 3 of Form N-1A, such as:

- Brokerage fees and commissions;
- Incentive fees (funds are not permitted to have incentive advisory fees unless they are structured as fulcrum fees, which already would be included in the fund's fee table);
- Commissions or other benefits in connection with the solicitation of participations in the pool (funds are permitted to charge sales loads and make payments pursuant to a Rule 12b-1 plan, which already would be included in the fund's fee table);
- Clearance fees and fees paid to national exchanges and self-regulatory organizations;
- For principal-protected pools, any direct or indirect costs to the pool associated with providing the protection feature;
- Any costs or fees included in the spread between bid and ask prices for retail forex transactions; and
- Any other direct or indirect cost.[56]

These fees and expenses must be presented together with the break-even analysis. Although the break-even analysis and fees disclosure required under the CFTC framework is conceptually similar to the fee table and total annual expense examples required by Form N-1A to be included in a fund's summary prospectus, the CFTC showed deference to the SEC's rigid requirement that only information required by or permitted by Items 1 through 8 of Form N-1A be included in the summary section of a fund's prospectus. Accordingly, this should cause a minimal cost burden for those funds that have migrated to the summary prospectus delivery regime. However, having two different sets of fee disclosures in two different places in a fund's prospectus may appear disjointed and potentially confuse investors. In this regard, funds may want to request that the SEC and CFTC provide guidance as to how funds can best alleviate any potential shareholder confusion regarding how the two sets of fee disclosures fit together.

Performance. Registered investment companies no longer able to rely on Rule 4.5 will be required to comply with the performance-reporting requirements of Rule 4.25 in their disclosure documents. While certain of the CFTC performance-reporting requirements overlap with those required by the SEC and federal securities laws, others do not. Most notably, Rule 4.25(c) requires commodity pools that have less than a three-year operating history to disclose the performance of each other pool (including private pools) operated by the CPO (and the CTA, if applicable) and each other account traded by the CPO (and the CTA, if applicable).

In the Proposed Rules, the CFTC specifically recognizes that such reporting may conflict with the SEC's position generally prohibiting the use of related account past performance without substantial disclosure and seeks comment on whether it should try to harmonize its past performance-reporting requirements with the positions of the SEC. To the extent such performance disclosure is required, the CFTC is proposing that the performance of other pools and accounts may be included in the fund's SAI instead of its prospectus. Nonetheless, any disclosure in a fund's SAI regarding a private pool advised by the adviser may jeopardize the private pool's ability to rely on its private offering exemption under 1933 Act (for example, Regulation D) and comply with the private offering requirements under the 1940 Act (for example, Sections 3(c)(1) and 3(c)(7)). The

Harmonization Release notes that the CFTC has had preliminary discussions with the SEC Staff on the issue of disclosure of past performance generally, and the SEC Staff has stated that it would consider requests for no-action relief regarding the performance presentations, if necessary and appropriate.[57] However, the Harmonization Release does not address whether the CFTC and the SEC specifically discussed the issues surrounding the inclusion of private pool information in a publicly disseminated fund offering document. Therefore, it would be appropriate for affected advisers to request clarification on this issue from the CFTC and SEC.

Although not addressed in the Harmonization Release, the requirements of Rule 4.25(c) also conflict with the Financial Industry Regulatory Authority's (FINRA's) rules prohibiting broker-dealers from using fund sales material that includes the performance of other accounts. Accordingly, funds should request that the CFTC include FINRA in their discussions with the SEC regarding the harmonized performance disclosure requirements.

Updating Amendments. CFTC Rule 4.26 requires that a new disclosure document be prepared and filed after nine months of use. In contrast, registered investment companies are generally required to update their prospectuses annually.[58] To remedy this inconsistency, the Proposed Rules would permit CPOs (and CTAs) to file updates to disclosure documents 12 months from the date of the documents being updated.

In addition, generally, CPOs are not permitted to distribute a new or updated disclosure document until the NFA has reviewed and accepted the disclosure document. Registered investment companies, on the other hand, file a registration statement pursuant to Rule 485(b) under the 1933 Act as part of their annual update process that does not require prior review by the SEC and is automatically effective upon filing, unless otherwise designated. Further, fund supplements filed pursuant to Rule 497 under the 1933 Act also become effective automatically upon filing. In response to requests from commenters that the CFTC should provide funds relief from NFA pre-review requirements in light of the fact that funds are continuously offered, the CFTC reminded the industry that current Rule 4.26(d)(2) permits CPOs to provide updated disclosure documents to pool participants at the same time such updates are filed with the NFA. In this regard, one suggested approach outlined in the Harmonization Release contemplates that funds will post their updated documents, with any changes highlighted, on their websites at the same time they file the updated documents with the NFA. Then, upon completion of the NFA review process, funds would post their final documents.

Although this approach may provide funds the flexibility to use offering documents while still under review by the NFA, funds can expect to receive two sets of regulatory comments on all prospectus filings and, possibly, NFA comments on prospectus supplements. It is not unreasonable to imagine a situation in which a fund will be forced to supplement its final prospectus following its annual update filing with the SEC to reflect additional NFA comments. Alternatively, funds may be forced to consider the feasibility of filing with the NFA prior to filing with the SEC documents that become immediately effective upon filing with the SEC. However, a question remains as to whether funds will be hesitant to immediately print and mail important supplement information based on fears that NFA comments on the supplement will force the fund to reprint and re-mail the supplement. In any event, this new regulatory review process needs to be factored into a fund's filing, printing and offering schedule, especially when a fund complex is seeking to launch a new product.

In light of the proposed requirement to file offering documents with the NFA, advisers and funds should begin to evaluate the feasibility of, and costs related to, using separate offering documents for those funds subject to the CFTC rules. Further, in light of the different disclosure requirements that would be applicable to funds subject to the CFTC rules (for example, break even analysis and more expansive fee and expense disclosure), advisers and funds should consider whether the inclusion of such funds in the same prospectus with funds not subject to the CFTC rules would result in investor confusion.

Cautionary Legend. The Proposed Rules also address the legends required by the CFTC and SEC to be included on the cover pages of a pool's disclosure document and a fund's prospectus, respectively. Instead of including two statements on the cover page of a fund's prospectus that meet the requirements of CFTC Rule 4.24[59] and Rule 481(b)(1) under the 1933 Act,[60] the CFTC proposes that a fund include a single statement that combines the language required by both Rule 4.24 and Rule 481(b)(1). We would expect this disclosure to be similar to the following:

> Neither the US Securities and Exchange Commission nor the Commodity Futures Trading Commission has approved or disapproved these securities, determined if this prospectus is truthful or complete, OR passed upon the merits of investing in this product. Any representation to the contrary is a criminal offense.

Harmonization of Periodic Reporting Requirements and Certifications

CFTC Rule 4.22 requires that a CPO periodically distribute to each investor in each pool it operates an account statement consistent with Rule 4.22. Account statements must be distributed monthly for pools with net assets of more than $500,000 and at least quarterly for all other pools. In the Proposed Rules, the CFTC recognizes that this requirement may be more burdensome than the semiannual reporting requirement applicable to registered investment companies. Nonetheless, the CFTC does not propose to alter the content or eliminate the monthly delivery requirements, in large part because the CFTC believes that the information required to prepare the account statement should be readily available to the CPO in accordance with applicable recordkeeping requirements. The CFTC's proposed expansion of the exemption provided by Rule 4.12(c), however, would provide relief from the monthly delivery requirement so long as the CPO makes such fund information available on its website.

Another area where current SEC and CFTC requirements differ is the required certification on periodic and annual reports. CFTC Rule 4.22(h) requires the individual making the certification on behalf of the CPO to make an oath or affirmation that, to the best of his or her knowledge and belief, the information contained therein is accurate and complete. The certification required by the SEC in a fund's Form N-CSR (the reporting form used by funds for filing their annual and semiannual reports to shareholders with the SEC) is similar and tracks the language of Section 11 of the 1933 Act: "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." While the CFTC certification must be included in reports provided to pool participants, the fund Form N-CSR certification is made available through the EDGAR system, but is not provided to fund shareholders. In the Harmonization Release, the CFTC stated that it will "accept the SEC's certification as meeting the requirement under Rule 4.22(h), as long as such certification is part of the Form N-CSR filed with the SEC."[61]

Harmonization of Recordkeeping Requirements

CFTC Rule 4.23 requires a CPO to make and keep the requisite books and records "at its main business office." Registered investment companies, on the other hand, often maintain their books and records with third parties, such as a fund's administrator, custodian, transfer agent, or investment adviser. The Proposed Rules would expand Rule 4.12(c) to permit registered investment companies and their CPOs to continue to maintain their records with third parties subject to certain conditions. In particular, the books and records that the CPO will not keep at its main business office must be maintained by the registered investment company's administrator, distributor, or custodian, or a bank or registered broker or dealer acting in a similar capacity with respect to the registered investment company. Notably, a fund's transfer agent and investment sub-adviser and professional storage and maintenance firms are not included within this list of eligible recordkeeping entities. We expect fund companies to raise this issue with the CFTC during the comment period. To take advantage of this relief, in the notice it files with the NFA, the CPO must specify the books and records that each person will be keeping and make certain representations, including that it will promptly amend the statement if the contact information or location of any of the books and records required to be kept by Rule 4.23 changes, and disclose in the pool's disclosure document the location of its books and records that are required under Rule 4.23.

CFTC Sought Additional Comment on Areas in Need of Harmonization

In the Harmonization Release, the CFTC sought comment on several areas, including whether there are other provisions of Part 4 of the CFTC's regulations that might require harmonization and whether the CFTC's proposals regarding break-even analysis and performance reporting strike the right balance between providing material information and reducing conflicting or duplicative disclosure obligations imposed on funds. In recognition of the NFA's suggestion that the CFTC "consider granting similar relief to public commodity pools to avoid giving one structure a competitive advantage over other similar structures in the marketplace,"[62] the CFTC also sought comment as to whether the proposed harmonization provisions should be applied to operators of pools that are not registered investment companies.

The Proposed Rules are promising for registered investment companies now faced with complying with the CFTC's regulatory regime, but it seems likely that other conflicts between the requirements of the two regulatory regimes will surface once registered investment companies and their CPOs begin to prepare their new hybrid prospectus-disclosure document. In any event, registered investment companies that are unable to avail themselves of the revised Rule 4.5 exemption will likely face significant costs associated with interpreting and drafting their initial filings under the newly adopted dual regulatory framework.

What Should Fund Advisers Be Doing Now?

The changes to CFTC Rule 4.5 and related rules and the proposed harmonization rules will affect most advisers to registered investment companies. Between now and December, such advisers should, at a minimum, take the following steps:

- Take an inventory of all of their registered fund offerings, noting levels of commodity use, including swaps, and those funds that use CFCs;

- Evaluate levels of commodity use in connection with the *de minimis* tests;

- For those advisers with funds near the thresholds for commodity pool registration, review the two trading thresholds set forth in Rule 4.5 and the bona fide hedging exemption to determine whether procedures could be implemented to ensure that the pools remain below these limits so that the advisers would not need to register as CPOs;

- Review the extent to which CPO registration implicates additional liability for the adviser, and review the firm's insurance coverage;

- Review fund disclosure documents, marketing materials, and fund names to ensure that those funds that meet the thresholds for exclusion do not otherwise trigger CPO registration requirements in light of the marketing restriction imposed under Rule 4.5;

- Review each fund's website to ensure that the fund is capable of complying with any new posting obligations that may be required under the proposed harmonization rules;

- Begin considering the disclosure and delivery implications of the proposed harmonization rules, including the calculation of a break-even analysis, disclosure of additional fund fees, disclosure of past performance for funds with fewer than three years of operations, and website posting of information; and

- Review the reporting requirements of Form CPO-PQR to ensure that their systems are set up to capture the necessary information.

Notes

1. For ease of reference, this article may use the term "mutual fund" or "fund" to refer to an open-end management investment company (or series thereof) registered under the Investment Company Act of 1940. The new rules discussed herein, however, apply equally to registered closed-end investment companies and exchange-traded funds that have registered as unit investment trusts.

2. *See Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations,* 77 Fed. Reg. 11,252 (Feb. 24, 2012) (hereinafter, Adopting Release). *See also Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations,* 76 Fed. Reg. 7976 (Feb. 11, 2011) (hereinafter, Proposing Release).

3. *See* Section 1a(10) of the CEA and CFTC Rule 4.10(d) (1). Commodity interests include futures contracts, options on futures contracts, security futures, swaps, certain foreign exchange and commodity options.

4. *See* 7 U.S.C. § 1a(11).

5. *See Commodity Pool Operators and Commodity Trading Advisors; Exemption From Registration and From Subpart B of Part 4 for Certain Otherwise Regulated Persons and Other Regulatory Requirements,* 49 Fed. Reg. 4778-02 (Feb. 8, 1984); CFTC Interpretive Letter No. 96-76 n.3 (Oct. 21, 1996), available at *http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/96-76.pdf.*

6. Banks, benefit plans, and insurance companies currently relying on the exemption are unaffected by the recent amendments to Rule 4.5 and may continue to conduct their commodity pool businesses without registration. These regulated entities, however, will be subject to the marketing restriction and the annual notice requirement, discussed below.

7. Bona fide hedging transactions and positions are defined at CFTC Rules 1.3(z) and 1.51, as further discussed below.

8. *See Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues,* 68 Fed. Reg. 47,221 (Aug. 8, 2003); *see also Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors,* 68 Fed. Reg. 12,622 (Mar. 17, 2003).

9. When claiming the Rule 4.5 exclusion, a fund was required to represent to the CFTC that (i) the fund will disclose in writing to each participant, whether existing or prospective, that the fund has claimed an exclusion from the definition of the term "commodity pool operator" under the CEA and, therefore, is not subject to registration or regulation as a pool operator under the CEA; and (ii) such disclosure will be made in accordance with the requirements of any federal or state regulatory authority to which the fund is subject. In most instances, funds included this disclosure in their Statements of Additional Information (SAIs). Funds were also required to submit to special calls from the CFTC in order to demonstrate their compliance with the provisions of Rule 4.5. For a discussion of the coverage requirements under the Investment Company Act, *see Securities Trading Practices of Registered Investment Companies*, Investment Company Act Rel. No. 10,666, 44 Fed. Reg. 25,128, 25,129 (Apr. 18, 1979). *See also* Georgia Bullitt, et al., "Legal Considerations for Registered Investment Companies Investing in Derivatives," *The Investment Lawyer* (Aug. 2010 and Oct. 2010).

10. *See SEC Staff Evaluating the Use of Derivatives by Funds,* SEC Release 2010-45 (Mar. 25, 2010), available at *http://www.sec.gov/news/press/2010/2010-45.htm;* see also, Bullitt, et al., supra n.9.

11. *See* Letter from Mr. Thomas W. Sexton, III of NFA to Mr. David A. Stawick of CFTC (Aug. 18, 2010), available at *http://www.nfa.futures.org/news/newsPetition.asp?ArticleID=3630*.

12. In a comment letter, however, the NFA suggested broadening the scope of the coverage to apply the same types of limits on banks and trust companies as the revised rule does on registered investment companies. *See* Letter from Thomas W. Sexton, III of NFA to David A. Stawick of CFTC, Re: Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (Apr. 12, 2011).

13. Adopting Release, *supra* n.2 at 11,254. *See also* Proposing Release, *supra* n.2 at 7984.

14. *See* Adopting Release, *supra* n.2 at 11,255.

15. Bona fide hedging is further discussed below.

16. Under the final rules for determining the "net notional value," the registered investment company may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade and swaps cleared on the same derivatives clearing organization.

17. Although the Adopting Release clearly indicates that the net notional test in Rule 4.5 was intended by the CFTC to be an alternative trading threshold, the actual text of Rule 4.5 as originally amended suggested that an entity must satisfy both trading thresholds in order to rely on the Rule 4.5 exclusion. On March 26, 2012, the CFTC published clarifying changes to the amended rules that make it clear that only one of the thresholds must be satisfied

by entities relying on the amended Rule 4.5 exclusion. *See Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations*, 77 Fed. Reg. 17,328 (Mar. 26, 2012).

18. For futures contracts, notional value is calculated by multiplying the size of a futures contract expressed in contract units by the current market price per unit of the contract (*e.g.*, contracts on stock indices are generally in units of a certain dollar amount times the price of the index) by the number of contracts held. For options on futures contracts, notional value is calculated by multiplying the number of contracts on which the pool has an option by the size of the contracts expressed in contract units, and adjusted by its delta, by the strike price of the option per unit. For retail forex transactions, notional value is calculated by calculating the value in US dollars for such transaction at the time the transaction was established, excluding for this purpose the value in US dollars of offsetting long and short transactions. The notional value of swaps will be determined consistent with the provisions of 17 C.F.R. part 45. We note, however, that 17 C.F.R. part 45 presently does not address the determination of notional value of swaps.

19. *See* Adopting Release, *supra* n.2 at 11,263.

20. *See id.* at 11,257 ("The [CFTC] does not believe that it is proper to exclude from the [CFTC's] oversight those entities that are using an index or other so-called 'passive' means to track the value of other derivatives. Establishing 'active' versus 'passive' use of derivatives as a criterion for entitlement to the exclusion would introduce an element of subjectivity to an otherwise objective standard and make the threshold more difficult to interpret, apply, and enforce. It also could have the undesirable effect of encouraging funds to structure their investment activities to avoid regulation. Moreover, the use of an index or other passive investment vehicle by a large number of investment companies can amplify the market assumptions built into an index or other vehicle.").

21. *See* Transcript of CFTC Staff Roundtable Discussion on Proposed Changes to Registration and Compliance Regime for Commodity Pool Operators and Commodity Trading Advisors (Roundtable Transcript), at 19, 25, 30, 76-77, 87-90, available at *http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission27_070611-trans.pdf*.

22. *See* Notice of Proposed Determination on Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25,774 (May 5, 2011).

23. *See, e.g.*, Roundtable Transcript, *supra* n.21 at 69-70.

24. *See id.* at 69-71.

25. *See, e.g.*, Letter from Ms. Karrie McMillan of the Investment Company Institute to Mr. David A. Stawick of CFTC (Apr. 12, 2011).

26. *See* CFTC Rule 4.5(c)(2)(iii). "Bona fide hedging" is defined in CFTC Rules 1.3(z)(1) and 151.5. Section 737 of the Dodd-Frank Act amended the CEA to add Section 4a(c)(2), which directs the CFTC to define what constitutes a bona fide hedging transaction or position as a transaction or position within a certain framework. In January 2011, the CFTC proposed, and in November 2011 the CFTC adopted, Rule 151.5 pursuant to this authority, which sets forth a definition of "bona fide hedging." *See Position Limits for Futures and Swaps*, 76 Fed. Reg. 71,626 (Nov. 11, 2011).

27. *See* Adopting Release, *supra* n.2 at 11,256 n.49.

28. *See* Position Limits for Futures and Swaps, *supra* n.26.

29. *See* 7 U.S.C. §1a(19).

30. *See* Position Limits for Futures and Swaps, *supra* n.26 at 71,643.

31. As proposed by the CFTC, the marketing restriction would have prohibited the marketing of interests in the registered investment company "as a vehicle for trading in (or otherwise seeking investment exposure to) the commodity futures, commodity options, or swaps markets." The CFTC agreed with industry comments that the clause "or otherwise seeking investment exposure to" created uncertainty in its application and, therefore, removed this clause.

32. With respect to its reasoning for deeming the use of a CFC to be an appropriate factor in determining whether the registered investment company violates the marketing restriction, the CFTC noted in the Adopting Release that a registered investment company's use of a CFC may indicate that the company is engaging in derivatives trading in excess of the trading threshold given that most funds use CFCs to invest up to 25% of their assets in derivatives.

33. *See* Adopting Release, *supra* n.2 at 11259.

34. Adopting Release, *supra* n.2, at 11,259.

35. Although in mid-2011 the IRS stopped issuing private letter rulings on mutual funds investing in CFCs that invest in commodities and commodity-linked derivatives (and such rulings were the topic of a recent Senate hearing), we expect that mutual funds will continue to invest in commodities and commodity-linked derivatives through appropriately operated and structured CFCs until such time as the IRS issues guidance to the contrary or Congress passes legislation to limit or eliminate such activity.

36. *See* Adopting Release, *supra* n.2 at 11,260.

37. *See id.*

38. Prior to the Adopting Release, investment advisers that advised both a registered investment company and the registered investment company's wholly owned CFC typically relied on an exemption from registration as a CPO provided by CFTC Rule 4.13(a)(4). Because the Adopting Release also rescinded Rule 4.13(a)(4), these registered investment advisers will be required to register as CPOs or CTAs with respect to the CFC as well as the parent registered investment company. However, as CPO to the CFC and the parent registered investment company,

the CPO will not be required to prepare for the CFC and provide to the registered investment company a disclosure document, monthly account statements, or annual reports because CFTC Rules 4.21(a)(2), 4.22(a)(4), and 4.22(c)(8), respectively, each exclude compliance with respect to a commodity pool operated by a CPO that is the same as or that controls, is controlled by, or is under common control with the CPO of the offered pool. If the CPOs of the CFC and the parent registered investment company are unrelated entities, the CPO to the CFC may still be able to rely on the relief from certain obligations imposed by Part 4 of the general regulations under the CEA provided by CFTC Rule 4.7.

39. *See* Adopting Release, *supra* n.2, at 11,264.

40. *Id.* at 11,259. It should be noted, however, that the CFTC did not provide formal guidance indicating that directors or trustees of nonregistered investment company entities (*e.g.*, CFCs) were not required to individually register as CPOs if such entities are subject to CPO registration.

41. Rule 4.14(a)(4) provides that a person is not required to register as a CTA with respect to a pool if such person is registered as a CPO with respect such pool. Accordingly, if an investment adviser is required to register as a CPO with respect to a fund due to the amendments to Rule 4.5, the adviser would not need to register as a CTA with respect to the fund.

42. Section 712 of the Dodd-Frank Act directs the SEC and CFTC to jointly define the terms "Swap," "Security-Based Swap," and "Security-Based Swap Agreement." In May 2011, the SEC and CFTC jointly proposed definitions, but, to date, the final definitions have not been adopted. *See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 76 Fed. Reg. 29,818 (May 23, 2011). The SEC has indicated that it expects product definitions required by Section 712 of the Dodd-Frank Act to be in place by June 2012. The CFTC had listed "product definitions" on its rule-writing schedule from January to March 2012. As of the time this article went to print, such definitions had not yet been adopted.

43. Status as a principal or AP is determined by the definitions set forth by the CFTC. An individual's status as a principal of a CPO would be determined by the individual's: (1) ability to control the CPO's business activities; (2) formal title or position with the CPO; and (3) financial or ownership interest in the CPO. A company may be a principal of a CPO either because it is a general partner (if the CPO is organized as a partnership) or because of its ownership or financial stake in the CPO. Unlike individuals, a company's status as a principal of a CPO based on ownership or capital contribution is determined solely by its direct relationship with the CPO. An AP generally is an individual who solicits orders, customers, or customer funds (or who supervises persons so engaged) on behalf of a CPO. An AP is, in effect, anyone who is a salesperson or who supervises salespersons. *See* CFTC Rule 3.1(a) (definition of principal) and Rule 1.3(aa)(3) (definition of an AP of a CPO).

44. *See* Adopting Release, *supra* n.2, at 11,254.

45. *See* No. 09-525, slip op. 564 U.S. ___ (June 13, 2011). On June 13, 2011, the US Supreme Court, in a 5-4 ruling, held that a mutual fund adviser and its parent could not be held liable in a private suit under Rule 10b-5 under the 1934 Act for allegedly false statements contained in a mutual fund prospectus, because the mutual fund itself, rather than the adviser, "made" the statements in the prospectus. In summary, the Court held that the "maker" of a statement for purposes of Rule 10b-5 liability is the person or entity "with ultimate authority over the statement, including its content and whether and how to communicate it." Applying this rule to the facts underlying the case, the Court held that neither the adviser nor its parent company was the "maker" of the statements in any of the fund prospectuses, notwithstanding that the adviser assisted with their preparation, because the fund itself had ultimate authority over the statements as they were filed with the SEC.

46. This review should also be undertaken with regard to any CFC managed by the adviser.

47. *See* CFTC Rule 4.27, as amended by the Adopting Release.

48. *See* Adopting Release, *supra* n.2, at 11,267.

49. Despite requests from commenters, the CFTC also declined to lessen the reporting obligations under Form CPO-PQR, even though certain information is already collected through the CFTC's large trader reporting system, noting that "the scope of information sought through Forms CPO-PQR and CTA-PR will provide [the CFTC] with substantially more detail regarding the activities of entities engaged in derivatives trading and will better enable it to assess the risk posed by a pool or CPO as a whole." Adopting Release, *supra* n.2, at 11,268. In addition, the CFTC declined to lessen the reporting obligations under Form CPO-PQR even though certain requested information is duplicative of the information funds report on Form N-SAR with the SEC.

50. *See Harmonization of Compliance Obligations for Registered Investment Companies Required To Register as Commodity Pool Operators,* 77 Fed. Reg. 11,345 (Feb. 24, 2012) (hereinafter Harmonization Release).

51. Comment Letter, dated April 12, 2011, to David A. Stawick, Secretary of the CFTC, from the NFA Regarding Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations; Proposed Rule, 76 Fed. Reg. 7976 (Feb. 11, 2011).

52. An investment adviser who is registered as a CPO for a registered investment company that conducts a private offering of its shares (*i.e.*, the company is only registered under the 1940 Act) may be able to rely on CFTC Rule 4.7 for relief from the disclosure, recordkeeping, and reporting requirements. In order to rely on this relief, Rule 4.7 requires that the interests in the fund be offered solely to "qualified eligible persons" (QEPs) in an offering exempt from registration under the 1933 Act. As amended, however, Rule 4.7 would still require the provision of audited annual financial statements.

53. Harmonization Release, *supra* n.50, at 11,346.

54. The Harmonization Release contemplates its application to closed-end funds registered on Form N-2 throughout, which is generally similar to how the Proposed Rules would affect open-end investment companies that file on Form N-1A; however, for purposes of this article, we will focus on the application to N-1A registrants (*e.g.*, mutual funds and ETFs that are structured as open-end investment management companies).

55. Harmonization Release, *supra* n.50, at 11,347.

56. Pursuant to Item 3 of Form N-1A, registered investment companies are required to report "Other Expenses" in their prospectus fee tables. Other Expenses include all expenses (except extraordinary expenses) not otherwise disclosed in the registered investment company's fee table that are deducted from the registered investment company's assets or charged to all shareholder accounts and reported as expenses in the registered investment company's statement of operations. As a result, certain of the fees and expenses required by CFTC Rule 4.24(i) may already be included in Other Expenses.

57. *See* Harmonization Release, *supra* n.50, at n.30.

58. Section 10(a)(3) of the 1933 Act requires that "when a prospectus is used more than nine months after the effective [date] of the registration statement, the information contained therein shall be as of a date not more than sixteen months prior to such use," which effectively results in an annual updating requirement for Form N-1A registrants.

59. CFTC Rule 4.24 currently requires a commodity pool to state on the cover of its Disclosure Document: "The Commodity Futures Trading Commission has not passed upon the merits of participating in this pool nor has the Commission passed on the adequacy or accuracy of this disclosure document."

60. Rule 481 requires a registered investment company to state on the cover of its prospectus a legend that indicates that the SEC has not approved or disapproved of the securities or passed upon the accuracy or adequacy of the disclosure in the prospectus and that any contrary representation is a criminal offense. Rule 481 provides two example disclosures.

61. Harmonization Release, *supra* n.50, at 11,348.

62. *Id.*Do You Really Want to Do That? IRAs and the Prohibited Transaction Provisions