The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 25888

February 10, 2012

CFTC Adopts Final Amendments to Rule 4.5 Exclusion and Proposes Limited Relief From Certain Regulatory Requirements; Conference Call on February 22

[25888]

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TO: SEC RULES COMMITTEE No. 12-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 7-12
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 7-12
ETF ADVISORY COMMITTEE No. 3-12
CHIEF COMPLIANCE OFFICER COMMITTEE No. 2-12
SMALL FUNDS COMMITTEE No. 4-12 RE: CFTC ADOPTS FINAL AMENDMENTS TO RULE 4.5 EXCLUSION AND PROPOSES LIMITED RELIEF FROM CERTAIN REGULATORY REQUIREMENTS; CONFERENCE CALL ON FEBRUARY 22

On February 8, 2012, the Commodity Futures Trading Commission ("CFTC") adopted amendments to several of its rules relating to commodity pool operators ("CPOs"), including Rule 4.5 ("Final Rule"). [1] The amendments to Rule 4.5 will significantly limit the ability of advisers to registered investment companies ("funds") to rely on the rule's exclusion from CFTC regulation, and will likely require many advisers to funds that invest in commodity futures, commodity options, and swaps to register as CPOs with the CFTC. In a release issued separately on the same day, the CFTC proposed relief from several of its regulatory requirements for those fund advisers that now will be required to register as CPOs with the CFTC ("Harmonization Proposal"). [2] The Final Rule and Harmonization Proposal are summarized below.

We will hold a conference call to discuss the Final Rule and the Harmonization Proposal on Wednesday, February 22 at 2:00 pm ET. The dial-in number for the call is 877-918-6703 and the passcode is 18432. If you plan to participate, please RSVP to Jennifer Odom at jodom@ici.gov or (202) 326-5833.

The Final Rule

Background

The Final Rule, which is substantially similar to the amended rule proposed by the CFTC in late January of last year ("Proposed Rule"), [3] conditions the availability of the Rule 4.5 exclusion on a fund's adherence to certain trading and marketing restrictions applicable to its positions in commodity futures, commodity options, and swaps. In re-emphasizing its basis for regulating advisers to funds, the CFTC states that "because Congress empowered the [CFTC] to oversee the derivatives market, the [CFTC] is in the best position to oversee entities engaged in more than a limited amount of non-hedging derivatives trading." [4] It further states that it "is focused on registered investment companies because it is aware of increased trading activity in the derivatives area by such entities that may not be appropriately addressed in the existing regulatory protections, including risk management and recordkeeping and reporting requirements." [5]

Trading Restriction

The Final Rule's trading restriction is similar to that of the Proposed Rule, and will require that a fund represent, in its notice of eligibility for the exclusion, that it will use commodity futures, commodity options or swaps solely for "bona fide hedging purposes." A fund may represent, however, that it will hold a limited amount of such instruments not for bona fide hedging purposes, generally subject to representations that the aggregate initial margin and premiums required to establish those positions will not exceed five percent of the liquidation value of the fund's portfolio. Although the CFTC acknowledges in the Rule 4.5 Adopting Release that margin levels for securities product futures are significantly higher than five percent, as may be the levels for swaps margining, it declined to raise the five percent threshold. The CFTC did, however, add an alternative net notional value test to the trading restriction, [6] which requires that the aggregate net notional value of commodity futures, commodity options contracts, or swaps positions not used solely for bona fide hedging purposes, determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the fund's portfolio. [7]

The CFTC declined to adopt a number of the recommendations by commenters with respect to the trading restriction, including exempting from the non-bona fide trading restriction instruments such as broad-based stock index futures, security futures, or financial futures contracts, and excluding funds that obtain exposure to the commodity markets through an index or other passive means. It also declined to expand the definition of bona fide hedging to include risk management.

Unlike the restrictions under the Proposed Rule, the Final Rule permits funds relying on it to hold commodity interests through wholly-owned subsidiaries, known as controlled foreign corporations ("CFCs"). The CFTC states that it "does not oppose the continued use of CFCs by registered investment companies, but it believes that CFCs that fall within the statutory definition of 'commodity pool' should be subject to regulation as a commodity pool." [8] As a result, the CFTC will require that the CPOs to such CFCs register with the CFTC unless they can otherwise claim an exclusion or exemption, potentially subjecting such CFCs to the CFTC's Part 4 regulations.

Marketing Restriction

As would have been required under the Proposed Rule, the Final Rule will require a fund to represent that it will not be, and has not been, marketing participations in the fund to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the

commodity futures, commodity options, or swaps markets. The CFTC, in response to comments, deleted the proposed clause “(or otherwise seeking investment exposure to) [the commodity futures, commodity options, or swaps markets].” It added, in the Rule 4.5 Release, however, guidance regarding the factors it will consider in determining whether an entity has violated the marketing restriction. The CFTC explains that it will determine whether there has been a violation of the marketing restriction “on a case by case basis through an examination of the relevant facts.” [9] The factors are:

- The name of the fund;
- Whether the fund's primary investment objective is tied to a commodity index;
- Whether the fund makes use of a CFC for its derivatives trading; [10]
- Whether the fund's marketing materials, including its prospectus or disclosure document, refer to the benefits of the use of derivatives in a portfolio or make comparisons to a derivatives index;
- Whether, during the course of its normal trading activities, the fund or entity on its behalf has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives;
- Whether the futures/options/swaps transactions engaged in by the fund or on behalf of the fund will directly or indirectly be its primary source of potential gains and losses; and
- Whether the fund is explicitly offering a managed futures strategy.

While the CFTC states that no single factor is dispositive, it explains that it will give more weight to the final factor in determining whether a fund “is operating as a de facto commodity pool.” [11]

Entity Required to Register as a CPO

The CFTC adopted the recommendation of commenters that the adviser to a fund is the entity that should register as a CPO, if registration is required. It indicated it would not be appropriate to require a member or members of a fund’s board of directors to register, as doing so would raise operational concerns for the fund, because it would pierce the limitation on the directors’ liability.

Compliance Dates

Compliance with the Final Rule for purposes of registration only will be required on the later of: (i) December 31, 2012 or (ii) 60 days following the adoption of final rules defining the term “swap” and establishing margin requirements for such instruments. [12] Compliance with the CFTC’s Part 4 recordkeeping, reporting, and disclosure requirements will be required 60 days following the effectiveness of a final rule implementing the CFTC’s Harmonization Proposal.

Other Aspects of the Adopted Rules

Periodic Disclosure by CPOs and CTAs

The CFTC has adopted, with limited changes from the proposal, new Forms CRO-PRQ and CTA-PR, which must be filed by all registered CPOs and CTAs, including fund advisers that will be required to register as CPOs. The CFTC states that it believes that “it is important to collect the data in Form CPO-PQR from registered investment companies whose activities require CPO registration to assess the risk posed by such investment vehicles to derivatives markets and the broader financial system.” [13] These forms will be filed electronically with the NFA, typically on an annual basis. To eliminate duplicative filings, certain persons who

are dually registered with the CFTC and Securities and Exchange Commission ("SEC") can satisfy some of their reporting obligations through the filing of Form PF, which has been jointly adopted by the two Commissions. The amount of information that a CPO or CTA will have to disclose on Forms CPO-PRQ and CTA-PR will vary depending upon both the size of the operator/adviser, and the number and size of the pools it advises for which information must be reported.

Risk Disclosures Regarding Swap Transactions

As proposed, the CFTC adopted final rules requiring that the mandatory risk disclosure statements for CPOs and CTAs also must include disclosure about certain risks specific to swaps transactions. The CFTC states that concerns that conflicting requirements are imposed on funds will be addressed through the Harmonization Proposal. [14]

Annual Filing of Notice of Eligibility

The CFTC adopted, with minor changes from the proposal, a requirement that persons claiming an exclusion from the definition of CPO (including under Rule 4.5) or an exemption from registration as a CPO or CTA would be required to affirm their notice of exclusion or exemption on an annual basis. This will need to be done electronically through the National Futures Association within 60 days of the end of the calendar year.;

The Harmonization Proposal

The CFTC states that the Harmonization Proposal is intended to address concerns raised by commenters that fund advisers that would be required to register as CPOs would be subject to duplicative, inconsistent, and possibly conflicting disclosure and reporting requirements. In response to these concerns, the CFTC has proposed several limited exemptions from its Part 4 regulations.

Delivery of Disclosure Documents, Periodic Reports, and Maintenance of Books and Records

The CFTC's regulations require that a registered CPO deliver to each prospective pool participant a disclosure document containing specified information including, under some circumstances, past performance information of other pools and accounts managed by the CPO. The CPO may not accept money from a prospective pool participant unless the CPO first receives from the prospective participant a signed and dated acknowledgment stating that the participant received the disclosure document. A registered CPO must provide account statements to pool participants on a monthly or, in some cases, quarterly, basis. And it must maintain the books and records required by the CFTC's regulations "at its main business office."

The CFTC proposes to make available to fund advisers that must register as CPOs certain of the relief it has provided to CPOs to commodity exchange-traded funds ("commodity ETFs") with respect to these provisions. [15] Subject to conditions, this would include relief from the disclosure document acknowledgment requirement, relief to permit the CPO to satisfy the disclosure document and account statement delivery requirements by posting documents on the CPO's Internet website, and relief to retain required books and records with specified third parties. [16] The CFTC, however, is not proposing relief for fund advisers from the content or timing of the monthly account statement requirement, as it believes that this information is readily available to funds.

Conflicts in Disclosure Requirements

The CFTC also addresses several areas in which the CFTC's and SEC's disclosure requirements conflict:

- Prior performance: As noted above, the CFTC regulations, in some circumstances require a CPO to disclose in a disclosure document the prior performance of pools and accounts other than the commodity pool it is offering, including disclosure which the SEC does not permit. The CFTC proposes to address this conflict by requiring that such prior performance be disclosed in a fund's statement of additional information. [17]
- Legend: The CFTC notes that the standard cautionary statement required to be included on a CPO disclosure document under CFTC regulations is different than the standard disclosure statement required on the cover page of a fund's prospectus by the Securities Act of 1933. The CFTC proposes a statement that instead combines the language of the disclosure statements. [18]
- Break-even point: A CPO disclosure document must include a "break-even point," which is a specific calculation intended to demonstrate to an investor the trading profit that a pool must realize in the first year for the investor to recoup its initial investment. The CFTC proposes to require that the break-even point must be disclosed in a fund's prospectus: (i) for an open-end fund, immediately following those disclosures required to be included in the summary prospectus; and (ii) for a closed-end fund, in the "forepart of the prospectus." [19]
- Disclosure of fees and expenses: CFTC regulations require CPOs to disclose certain fees and expenses in a different manner than funds. To address this difference, the CFTC proposes that any expenses that are not included in the Form N-1A fee table or in Item 3 of Form N-2 would be required to be disclosed in the prospectus, along with a tabular presentation of the calculation of the fund's break-even point.
- Updating of disclosure documents: The CFTC proposes to require CPOs and CTAs to file updates of all disclosure documents twelve months from the date of the document, rather than nine months as is currently required, to be consistent with updating requirements under the federal securities laws.
- Certifications: The certification language required by the CFTC and the SEC in their respective periodic and annual report certifications is not identical.; The CFTC proposes to accept the SEC's certification language, as long as the certification is part of the fund's Form N-CSR filing with the SEC.

Sarah A. Bessin
Senior Counsel

Rachel H. Graham
Senior Associate Counsel

endnotes

[1] Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, RIN 3038-AD30, available at

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912b.pdf ("Rule 4.5 Release"). The Final Rule was adopted by a 4-1 vote, with Commissioner Sommers dissenting.

[2] Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912.pdf ("Harmonization Release"). Comments on the Harmonization Proposal are due to the CFTC 60 days after the Harmonization Release is published in the Federal Register.

[3] See ICI Memorandum No. 24948 (February 4, 2011).

[4] Rule 4.5 Release, supra note 1, at 12.

[5] Id. at 14. The CFTC notes that "the SEC has also noted this increased trading activity and is reviewing the use of derivatives by investment companies." Id. (internal citations omitted).

[6] While the CFTC describes the net notional test in the Rule 4.5 Release as an alternative trading threshold, and that appears to be its intent, the actual text of the Final Rule suggests that an entity relying on the rule must satisfy the net notional test (it uses "and" rather than "or").

[7] The Final Rule includes a provision explaining how "notional value" must be calculated, and permits the netting of futures contacts with the same underlying commodity across designated contract markets and foreign boards of trade, and swaps cleared on the same designated clearing organization where appropriate.

[8] Rule 4.5 Release, supra note 1, at 31. The CFTC believes that a CFC wholly owned by a fund and used for trading commodity interest is "properly considered" a commodity pool.

[9] Rule 4.5 Release, supra note 1, at 26.

[10] The CFTC believes that a fund's use of a CFC may indicate that the company is engaging in derivatives trading in excess of the trading threshold.

[11] Rule 4.5 Release, supra note 1, at 27. Although the CFTC notes that a fund that does not explicitly offer a managed futures strategy could still be found to have violated the marketing restriction if its conduct satisfies "any number" of the other factors. It will not, however, consider disclosures to investors that a fund may engage in derivatives trading "incidental to its main investment strategy," along with associated risks, to violate the marketing restriction. It also will not consider dispositive if the name of a fund includes the terms "futures," "derivatives," or otherwise indicates a possible focus on such instruments.

[12] There is some ambiguity with respect to the compliance date, because a description of the compliance date earlier in the Rule 4.5 Release does not reference the adoption of rules establishing margin requirements.

[13] Id. at 55.

[14] The Harmonization Proposal does not appear to address this issue, however.

[15] See Rule 4.12 under the Commodity Exchange Act ("Commodity ETF Rule"). The CFTC

proposes in the Harmonization Proposal to provide CPOs to publicly offered commodity pools with similar relief to that it proposes for funds.

[16] The third parties permitted under the Commodity ETF Rule are limited to: the pool's administrator, distributor or custodian, or a bank or registered broker or dealer acting in a similar capacity with respect to the pool.

[17] The CFTC states, in the Harmonization Release, that it has had "preliminary discussions" with the SEC staff on this issue, and the staff stated it would consider requests for no-action relief regarding such presentations of prior performance, if necessary and appropriate. Harmonization Release, supra note 3, at n.27.

[18] The CFTC proposes two examples of possible language in the Harmonization Release at 27.

[19] For a closed-end fund, it appears that the break-even point would be required to be disclosed immediately following those disclosures required by the SEC to be included in the prospectus summary and financial highlights table, if any.
