PAUL HASTINGS
STAY CURRENT
A CLIENT ALERT FROM PAUL HASTINGS

August 2013

CFTC Adopts Final Harmonization Rules

BY THE INVESTMENT MANAGEMENT PRACTICE

On August 13, 2013, the Commodity Futures Trading Commission (the "CFTC") issued final rules clarifying the compliance obligations for investment advisers of registered investment companies ("RICs") that must register with the CFTC as commodity pool operators ("CPOs").[1] In February 2012, the CFTC narrowed the exclusions from the definition of "commodity pool operator" available under Rule 4.5 of the Commodity Exchange Act (the "CEA") for investment advisers to investment companies registered with the Securities and Exchange Commission (the "SEC") under the Investment Company Act of 1940. The amendments imposed a new *de minimis* trading threshold in order for such advisers to be excluded from the definition of a CPO. The amendments had the effect of requiring many more advisers to RICs that invest in commodity instruments (including certain types of derivatives) to register as CPOs than had been the case under the prior Rule 4.5 regime.[2] As of December 31, 2012, under the new Rule 4.5, advisers to entities that exceeded the *de minimis* trading threshold became subject to dual registration with both the CFTC and the SEC. Because the rules applicable to CPOs under the CEA were different, and sometimes inconsistent with, the rules applicable to RICs under the Investment Company Act of 1940 and the Securities Act of 1933, the CFTC adopted "Harmonization Rules" to resolve the duplicative, inconsistent, and possibly conflicting, disclosure and reporting requirements that would otherwise apply to dually registered CPOs of RICs.

The Harmonization Rules provide for a "substituted compliance regime" whereby CPOs of RICs that maintain compliance with the SEC's disclosure[3] (including the timing and frequency of disclosure), reporting and recordkeeping regime for RICs ("SEC RIC Rules") will be deemed to be in compliance with Part 4 of the CEA and its regulations, subject to certain conditions described below.[4] Importantly, in addition to allowing CPOs of RICs to follow the SEC's disclosure regime, the final Harmonization Rules also permit all CPOs (not only CPOs of RICs) to use third-party service providers to maintain their books and records, and all CPOs are no longer required to obtain the signed acknowledgement from investors of their receipt of the applicable disclosure document or prospectus.[5] CPOs of RICs that choose to rely on this substituted compliance regime, but fail to comply with SEC RIC Rules, will be deemed to be in violation of CTFC rules (as well as SEC RIC Rules) and therefore could be subject to dual enforcement actions by both the SEC and the CFTC.

A CPO of a RIC that chooses to comply with CFTC requirements through the substituted compliance regime (the option to comply with Part 4 requirements applicable to all CPOs remains available) will be required to:

- File a notice of its use of the substituted compliance regime with the National Futures Association ("NFA");

- For CPOs of RICs with less than three years of operating history, disclose in the prospectus the performance of all accounts and pools that are managed by the CPO and that have investment objectives, policies, and strategies substantially similar to those of the offered pool (in a manner consistent with SEC disclosure practices);
- File with the NFA the financial statements of the pool that it prepares pursuant to its obligations with the SEC; and
- File a notice with the NFA if it uses or intends to use third-party service providers for recordkeeping purposes, which notice will provide information about the third-party service provider as well as a statement from the third-party service provider agreeing to maintain the CPO's books and records consistent with CFTC regulation.

With respect to RICs that use a wholly-owned and controlled foreign subsidiary to obtain commodity exposure (a "CFC"), the Harmonization Rules provide that the CFC will not be required to prepare its own disclosure documents. If the CFC consolidates its financial statements with that of the RIC (which financial statements must be filed with the NFA), it will also not be required to prepare separate financial statements.

In addition, the Harmonization Rules amend certain provisions of the CFTC's regulations that apply to all registered CPOs (except CPOs of RICs) to provide that required disclosure documents must be updated on a 12-month basis rather than the current 9-month basis. CPOs of RICs that use the substituted compliance regime may continue to update their prospectus on a 16-month basis, in accordance with SEC RIC Rules.

The substituted compliance regime generally takes effect upon publication of the Harmonization Rules in the Federal Register. However, with respect to open-end funds, the requirement to amend the Rule 481 cautionary legend to add a reference to the CFTC, as well as the requirement to provide prior account performance information in prospectuses for funds with less than three years of operating history, will be effective 30 days after publication of the Harmonization Rules in the Federal Register and compliance with these requirements will be required when a new fund files its initial registration statement with the SEC or when an existing fund files its next post-effective amendment with the SEC (the Harmonization Rules do not indicate whether the SEC staff will accept post effective amendments filed to comply with the CFTC substituted compliance regime under Rule 485(a) (60 day SEC review) or Rule 485(b) (immediate effectiveness)). For closed-end funds, compliance will be required for a new fund when it files its initial registration statement or, for an existing fund, when it is required to update its registration statement. CPOs of RICs will be required to begin filing forms CPO-PQR and CTA-PR 60 days after publication of the Harmonization Rules in the Federal Register. Finally, with respect to amendments that pertain to CPOs that are not CPOs of RICs, compliance will be required 30 days after publication of the Harmonization Rules in the Federal Register.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

LONDON

Christian Parker
44.20.3023.5161
christianparker@paulhastings.com

LOS ANGELES

Arthur Zwickel
1.213.683.6161
artzwickel@paulhastings.com

NEW YORK

Domenick Pugliese
1.212.318.6295
domenickpugliese@paulhastings.com

Michael R. Rosella
1.212.318.6800
mikerosella@paulhastings.com

Jacqueline A. May
1.212.318.6282
jacquelinemay@paulhastings.com

Gary D. Rawitz
1.212.318.6877
garyrawitz@paulhastings.com

Christopher J. Tafone
1.212.318.6052
christophertafone@paulhastings.com

SAN FRANCISCO

David A. Hearth
1.415.856.7007
davidhearth@paulhastings.com

Mitchell E. Nichter
1.415.856.7009
mitchellnichter@paulhastings.com

WASHINGTON, D.C.

Wendell M. Faria
1.202.551.1758
wendellfaria@paulhastings.com

[1] "Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators," available at http://cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister081213.pdf.

[2] For more information, see *CFTC Adopts Final Rules Revising CPO and CTA Registration and Reporting Requirements: Significant Impacts for Mutual Funds and Private Investment Funds*, February 2012 (http://www.paulhastings.com/Resources/Upload/Publications/2118.pdf).

[3] The Harmonization Rules require that dual registrants change the legend required by Rule 481 of the Securities Act to state that neither the SEC nor the CFTC have approved or disapproved of the securities offered through the prospectus or passed on the adequacy of the prospectus.

[4] Specifically, the Harmonization Rules provide that CPOs of RICs will be deemed to be in compliance with sections 4.21, 4.22(a) and (b), 4.24, 4.25 and 4.26 of the CEA if they satisfy all applicable SEC RIC Rules.

[5] The Harmonization Rules also provide that, consistent with SEC RIC Rules, CPOs of RICs will not be required to make their records available to investors in the fund for inspection and copying. In addition, the Harmonization Rules will require that CPOs of RICs to begin filing forms CPO-PQR and CTA-PR, as required by section 4.27 of the CEA.