



## CFTC Compliance Obligations for CPOs and CTAs – Final Rule

### Executive Summary

The Commodity Futures Trading Commission (“CFTC”) recently released final rules that amend the compliance obligations of commodity pool operators (“CPOs”) and commodity trading advisers (“CTAs”) under Part 4 of its regulations, including a requirement for CPOs and CTAs registered solely with the CFTC to file new reports similar to those required of CPOs and CTAs by the CFTC and the Securities and Exchange Commission (“SEC”) on Form PF (please refer to RPL 12-02).

In general, the final rules:

- Rescind an exemption from CPO registration set forth in CFTC Rule 4.13(a)(4) (an exemption for CPOs of commodity pools offered solely to certain qualified eligible persons and institutional accredited investors);
- Reinstate a trading threshold and marketing restriction for registered investment companies claiming an exclusion from the definition of CPO provided under CFTC Rule 4.5 (effectively limiting the scope of the application);
- Require persons relying upon exemptions established by CFTC Rules 4.5, 4.13, and 4.14 to affirm on an annual basis the accuracy of their original notice of exemption;
- Rescind the relief in CFTC Rule 4.7 from the requirement for including certified financial statements in the annual report of pools,
- Adopt new data collection/periodic reporting forms for CPOs and CTAs (Form CPO-PQR and Form CTA-PR) under new Rule 4.27 and to be filed with the National Futures Association (“NFA”); and
- Impose new standard risk disclosure statements for CPOs and CTAs regarding their use of swaps.

The final rules will become effective April 24, 2012 except for the data collection requirements under Rule 4.27, which become effective July 2, 2012. In addition:

- CPOs that relied on the Rule 4.13(a)(4) exemption will be required to comply with the rescission of the exemption by December 31, 2012 by filing notice of reliance on a different exemption or registering with the CFTC as a CPO. All other CPOs must comply by April 24, 2012.
- CPOs required to register as a CPO pursuant to the amendments under CFTC Rule 4.5 must register by the later of December 31, 2012 or 60 days after the CFTC’s final rulemaking defining the term “swap.”
- Compliance with the reporting requirements of Rule 4.27 is required as of September 15, 2012 for CPOs with more than \$5 billion in assets under management and as of December 14, 2012 for all other CPOs and all CTAs.

## Background

Section 721 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the “Dodd-Frank Act”) amended the *Commodity Exchange Act* by adding “swaps” to the definition of a commodity pool (defined under Section 721 as “any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any commodity for future delivery, security futures product, or swap”). Any entity that operates a commodity pool must register with the CFTC as a CPO unless it meets one of a number of exemptions provided under the Part 4 regulations. Similarly, persons that, for compensation or profit, advise others, including commodity pools, regarding futures contracts, commodity options or swaps must register with the CFTC as a CTA. The CFTC has issued a proposed rule to define the term “swap,” which would impact the definitions of commodity pools and commodity interests used in its regulations. In particular, once finalized the addition of swaps will increase the size of an entity’s commodity pools and commodity interests and in turn will impact its compliance with the margin and liquidation value thresholds applicable to certain exemptions.

## Description

### Final Rules for CPO and CTA Compliance Obligations

#### Rescission of Rule 4.13(a)(4)

The final rules rescind the CFTC Rule 4.13(a)(4) “sophisticated investor” exemption from CPO registration, which is currently available to CPOs of private funds offered solely to certain “qualified eligible persons” and institutional “accredited investors.” The rescission is effective April 24, 2012 and CPOs relying on this exemption will be expected to register as a CPO no later than December 31, 2012 or file another notice of claim of exemption by that date. All other CPOs must comply by April 24, 2012. No grandfathering provisions were provided.

The final rules retain the CPO exemption for “de minimis trading” provided by CFTC Rule 4.13(a)(3). This exemption is limited to CPOs of funds whose commodity interest trading satisfies one of two quantitative standards:

- The aggregate initial margin and premiums required to establish commodity interest positions, determined at the time the most recent position was established, does not exceed 5 percent of the liquidation value of the fund’s portfolio (taking into account unrealized profits and losses) or
- The aggregate net notional value of the fund’s commodity interest positions does not exceed 100 percent of the portfolio’s liquidation value.

The CFTC has issued a proposed rule to define “swaps.” Once the final rule is finalized, “commodity interests” will be defined to include swaps.

#### Modification of Rule 4.5

A CPO of a registered investment company may rely on the exemption from registration provided under CFTC Rule 4.5 if its commodity interests, excluding bona fide hedging, meet one of two quantitative tests:

- A trading threshold that parallels the 5 percent margin test under Rule 4.13(3) - commodity interest positions, determined at the time the most recent position was established, do not exceed 5 percent of the liquidation value of the fund’s portfolio); or

- A net notional test that also parallels the net notional test under Rule 4.13(3) - the aggregate net notional value of the fund's commodity interest positions does not exceed 100 percent of the portfolio's liquidation value,

Further, the registered investment company may not market participations 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 will consider several factors when determining whether the marketing restriction has been met, including:

- 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 controlled foreign corporation for its derivatives trading;
- Whether the fund's marketing materials, including its prospectus or disclosure document, refer to the benefits of the use of derivatives in a portfolio or make comparisons to a derivatives index;
- Whether, during the course of its normal trading activities, the fund 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.

A fund relying on the Rule 4.5 exemption must file an annual notice with the NFA. Entities required to register with the CFTC pursuant to Rule 4.5 will be required to register by the later of December 31, 2012 or 60 days after the CFTC's final rulemaking defining the term "swap."

Funds that make use of controlled foreign corporations should note that the final rules deem CFCs wholly owned by registered investment companies and used for trading commodity interests to be commodity pools that must be assessed on their own characteristics to determine the applicability of registration rules or the availability of an exemption or exclusion. This assessment must be performed on the CFC as a standalone legal entity, independent of any parent registered investment company.

#### [Annual Notices Required for Reliance on Certain Exemptions](#)

The final rules require any person or entity that files a claim of exclusion or exemption from registration under any of CFTC Rules 4.5, 4.13 or 4.14 to either file a reaffirmation of the exclusion or exemption on an annual basis at calendar year end, withdraw the exclusion or exemption due to a cessation of the underlying activities, or withdraw the exclusion or exemption and apply for registration within 30 days of the anniversary of the initial filing. This requirement becomes effective April 24, 2012.

#### [Rescission of Rule 4.7](#)

The CFTC rescinded the exemption provided in Section 4.7(b)(3) from the requirement that financial statements contained in commodity pool annual reports be certified by certified public accountants under Section 4.22(c).

## Adoption of New Reporting Requirements under Rule 4.27

In October 2011, the CFTC adopted new Rule 4.27(d) to establish new reporting requirements for private funds that are registered with the CFTC and the SEC on new Form PF, as mandated by the Dodd-Frank Act. The final rules complete the provisions of new CFTC Rule 4.27 and require CPOs and CTAs registered with the CFTC to file information with the CFTC on new Forms CPO-PQR and CTA-PR, respectively. For entities registered with both the CFTC and the SEC, the new forms will serve as a supplement to Form PF.

### Form CPO-PQR

The new Form CPO-PQR is comprised of three schedules:

- Schedule A asks for basic information about the reporting CPO and more specific information about each of the CPO's pools, including questions about each pool's key relationship and investment positions. It is to be completed by all CPOs registered with the CFTC including CPOs that are also registered with the SEC as an investment adviser.
- Schedule B asks for information about each pool's creditors, counterparties, borrowings, and clearing mechanisms. It is to be completed by all CFTC CPOs with assets under management ("AUM") of more than \$150 million. A "mid-size CPO" has AUM of more than \$150 million and less than \$1.5 billion AUM.
  - CPOs also registered with the SEC that operate only pools that are private funds may satisfy this requirement with Form PF.
  - CPOs also registered with the SEC that operate pools that do not meet the definition of a private fund and did not elect to file Form PF must file Schedule B for each pool that is not a private fund.
- Schedule C asks for information about the aggregated portfolios of each of the pools that were not private funds and for certain risk metrics about the large pools that were not private funds. "Large pools" include any pool that has a net asset value individually, or in combination with any parallel pool structure, of at least \$500 million as of the close of business on any day during the reporting period. Schedule C is to be completed by CFTC CPOs with AUM of \$1.5 billion or more ("large CPOs").
  - CPOs also registered with the SEC that operate only pools that are private funds may satisfy this requirement with Form PF.
  - CPOs also registered with the SEC that operate pools that do not meet the definition of a private fund and did not elect to file Form PF must file Schedule C for each pool that is not a private fund.

Small and Mid-size CPOs must file the relevant portions of Form CPO-PQR annually within 90 days of the calendar year end. The compliance date for these CPOs is December 14, 2012 and the first Form CPO-PQR must reflect information as of December 31, 2012.

Large CPOs must file the relevant portions of Form CPO-PQR on a quarterly basis within 60 days of the end of each reporting period. The compliance date for Large CPOs is December 14, 2012 and the first Form CPO-PQR must be filed within 90 days of December 31, 2012 reflecting information as of the quarter ended December 31, 2012. However, large CPOs with more than \$5 billion in AUM as of June 30, 2012 are subject to a compliance date of September 15, 2012 and must file their first Form CPO-PQR within 60 days of September 30, 2012 reflecting information as of the quarter ended September 30, 2012.

### *Form CTA-PR*

All CTAs are required to file new Form CTA-PR annually within 45 days of the end of the fiscal year. The Form asks for information on the total number of trading programs offered by the CTA, the total assets directed by the CTA, the names of the pools advised by the CTA, among other information the CFTC considers to be “demographic.” The compliance date is December 15, 2012.

### *Confidentiality of Forms CPO-PQR and CTA-PR*

Parts of Forms CPO-PQR and CTA-PR are designated as nonpublic including:

- Form CPO-PQR Schedule A: Some or all of Questions 2, 3, 9, 10, 11 and 12, which address CPO AUM, pool information, pool marketers, pool statement of changes regarding AUM, pool monthly rates of return, and pool subscriptions and redemptions;.
- Form CPO-PQR Schedule B: All.
- Form CPO-PQR Schedule C: All; and
- Form CTA-PR: Names of pools advised by the CTA and the name of the reporting CPO for each pool.

### *New Risk Disclosures*

CPOs and CTAs that use swaps must include standard risk disclosures in all of their disclosure documents and in all updates disclosures filed after the effective date of the final rule (April 24, 2012). The standard risk disclosures caution investors about the risks associated with investments in swaps including market risk, credit risk, counterparty risk, funding risk, liquidity risk and operational risk.

## *Proposed Rules for Harmonization with SEC*

With the release of the final rules, the CFTC concurrently released a notice of proposed rulemaking that seeks public comment on reducing compliance burdens for registered investment companies that are required to register as CPOs under the changes to CFTC Rule 4.5. The proposed rule details proposed modifications to the CFTC’s Part 4 regulations that would “harmonize” the compliance obligations that apply to these dually registered investment companies. Comments are requested by April 24, 2012.

In particular, the CFTC is proposing to amend Rule 4.12(c) such that the CPO of any pool whose units of participation will be offered and sold pursuant to an effective registration statement under the Securities Act of 1933 may claim the relief from the delivery and acknowledgement requirements under Rule 4.21, certain periodic financial reporting obligations under Rule 4.22, and the requirement that records be maintained at the CPO’s main office under Rule 4.23 with respect to that pool.

The CFTC will not require entities that must register as CPOs because of the amendments to Rule 4.5 to comply with the CFTC’s compliance regime, including recordkeeping, reporting, and disclosure requirements, until final rules governing the compliance framework for registered investment companies subject to the CFTC’s jurisdiction (i.e., harmonization rules) are adopted. Once adopted, these entities will be subject to the CFTC’s recordkeeping, reporting, and disclosure requirements within 60 days following the effective date of the final rule.

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## Commentary

The adoption and release of these final rules represents a profound expansion of the regulation of investment managers and investment vehicles that invest in futures contracts and other commodity interests, either directly or indirectly, including family offices and foreign advisers, registered investment companies, and private funds.

The final rules were the subject of extensive industry comment and remain highly contentious even after adoption. Representative of the widely disparate view of the rules, CFTC Commissioner Jill Sommers' refused to vote in favor of adoption, and concluded a harsh dissenting opinion by stating:

*These rules are not mandated by Dodd-Frank, and I do not believe that the benefits articulated within the final rules outweigh the substantial costs to the fund industry. We admit in the preamble that we do not have enough information to determine the validity of requiring some of these entities to register. A more prudent approach would have been to gather the information first and then decide what constitutes sound policy.*

Perhaps the most contentious of the changes are the amendments to the Rule 4.5 exclusion from the definition of the term "commodity pool operator." While these changes reinstate limits on commodity trading that were a requirement of the 4.5 exclusion until 2003, the change brings those no longer able to rely on the amended 4.5 exclusion within the purview of the significant reporting requirements mandated by CFTC Rule 4.27 on Form CPO-PQR. This new reporting obligation will, in the CFTC's view, allow the assessment of "the risk posed by such investment vehicles to derivatives markets and the broader financial system."

Underlining the contentious nature of the Rule 4.5 amendment, the Investment Company Institute and US Chamber of Commerce filed a joint lawsuit on April 17, 2012 which challenges the amendments on the basis that the CFTC did not adequately perform a cost-benefit analysis in approving the final rules.

Rescission of the 4.13(a)(4) exemption will require the registration of thousands of hedge funds, fund-of-funds, and other pooled investment vehicles that invest in futures contracts and other commodity interests. These newly registered entities will be subject to the full array of CFTC and NFA regulation, including disclosure, reporting and recordkeeping requirements, and periodic examination by the staff of the National Futures Association ("NFA"). While many of these vehicles will be able to rely on the limited relief from reporting available in CFTC Rule 4.7, which was also amended to limit the previously available reporting relief, these vehicles will be subject to the Form CPO-PQR reporting requirements.

Investment managers and advisers to investment vehicles subject to modified regulatory requirements as a result of these amendments are advised to make preparations now in advance of rolling compliance dates.

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