

# CFTC Adopts Final Harmonization Rules for Commodity Pool Operators

September 9, 2013

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On August 13, 2013, the Commodity Futures Trading Commission (“**CFTC**”) adopted final regulations designed to harmonize the obligations of registered commodity pool operators (“**CPOs**”) under the CFTC Part 4 Regulations for commodity pools that are registered as investment companies (“**RICs**”) under the Investment Company Act of 1940 (“**1940 Act**”) with the obligations applicable to RICs under the 1940 Act and other securities laws. The final regulations also amend several Part 4 obligations as they apply to all registered CPOs with respect to all types of commodity pools.

In a significant departure from the harmonization rules proposed by the CFTC in February 2012,<sup>1</sup> the final regulations adopt a “substituted compliance” framework that permits a registered CPO of a RIC to comply with the disclosure, reporting, and recordkeeping requirements applicable to the RIC under the Securities Act of 1933, the 1940 Act, and regulations of the Securities and Exchange Commission (“**SEC**”) in lieu of complying with many of the analogous Part 4 requirements that would otherwise apply to the registered CPO. Such substituted compliance is available under the final regulations for some, but not all, Part 4 requirements. Thus, while the harmonization rules provide important relief for registered CPOs of RICs with respect to most Part 4 compliance obligations, the rules do not address all requirements with which registered CPOs must comply. For example, the harmonization rules do not address requirements for registered CPOs under NFA bylaws. In addition, the harmonization rules do not affect the applicability of CFTC rules governing commodity interest trading activities, such as position limits or new swap regulatory requirements. Therefore, registered CPOs should carefully review their compliance programs in light of the harmonization rules to ensure they are meeting all applicable requirements.

Contemporaneously with the CFTC’s adoption of the harmonization rules, the SEC’s Division of Investment Management issued a Guidance Update<sup>2</sup> that provides a summary of the Division’s views on the disclosure obligations of an investment adviser to a RIC that trades in commodity interests, including futures and swaps, and on related compliance issues.

<sup>1</sup> 77 Fed. Reg. 11345 (Feb. 24, 2012).

<sup>2</sup> SEC Staff of the Division of Investment Management, Guidance Update, No. 2013-05 (Aug. 13, 2013) available [here](#).

This memorandum provides an overview of the CFTC’s final harmonization rules. It also highlights aspects of the Guidance Update that should be considered by registered CPOs in implementing any new obligations applicable to them under the harmonization rules.

As discussed in more detail below, the majority of the harmonization rules became effective on August 22, 2013. The amendments to CFTC Regulation 4.12(c)(3)(i) (requiring past performance disclosure for registered CPOs of RICs that have less than three years of operating history) and to Regulation 4.26(a) (permitting all registered CPOs to use a disclosure document for up to 12 months) become effective on September 23, 2013 with a compliance date of November 22, 2013, as discussed further below. For registered CPOs of RICs that have less than three years of operating history, compliance with new Regulation 4.12(c)(3)(i), requiring performance disclosure for substantially similar accounts and pools, will be required when filing the first post-effective annual updating amendment to a registration statement (for open-end RICs), or the first updated registration statement (for closed-end RICs), to be filed on or after such compliance date. In addition, registered CPOs of RICs must begin initial reporting on Form CPO-PQR pursuant to Regulation 4.27 with respect to the period ending December 31, 2013, as discussed below.

**Summary of Substituted Compliance for CPOs of RICs**

A registered CPO of a RIC that complies with applicable SEC Requirements is not required to:

- prepare separate disclosure documents or account statements;
- disclose the break-even point of a pool;
- disclose past performance of other pools managed by the CPO (except for a CPO of a RIC that has less than three years of operating history);
- include the standard CFTC cautionary statement, provided that the SEC cautionary statement used also refers to the CFTC;
- include the standard CFTC risk disclosure statement; or
- make the RIC’s books and records available for inspection by pool participants.

**Background**

In February 2012, the CFTC amended Regulation 4.5 under the Commodity Exchange Act (the “**CEA**”) to narrow the exclusion from regulation as a CPO that had previously been available with respect to RICs. Under revised Regulation 4.5, many advisers to RICs that used more than a *de minimis* level of futures, swaps, or other commodity interests as part of their investment program were required to register as CPOs with the CFTC. Without CFTC action, the requirements applicable to CPOs under Part 4 of the CFTC’s Regulations would have applied with respect to RICs in addition to those requirements already applicable to them under the Securities Act of 1933, the 1940 Act, and SEC rules (“**SEC Requirements**”).

Recognizing that dual registration with the CFTC and SEC could subject CPOs of RICs to different, and at times conflicting, compliance obligations, the CFTC deferred the applicability of certain Part 4 obligations applicable to CPOs with respect to RICs, pending the adoption of rules to harmonize the agencies’ requirements applicable to RICs and their CPOs.

The final harmonization regulations, which do not provide relief from the requirement for a CPO to register with the CFTC, are designed to provide relief to RICs from those Part 4 disclosure, reporting, and recordkeeping requirements applicable to CPOs where the CFTC has determined that existing SEC Requirements are substantially similar to the Part 4 requirements.

## Treatment of CPOs for RICs

The final harmonization rules amend CFTC Regulation 4.12 to provide relief from most, but not all, Part 4 disclosure, reporting and recordkeeping obligations applicable to CPOs with respect to RICs.

### General Framework of Substituted Compliance

Borrowing the concept of substituted compliance from its cross-border swap regulatory guidance, the CFTC's Part 4 harmonization framework allows CPOs of RICs to comply with SEC Requirements applicable to the RIC in lieu of complying with the analogous Part 4 requirement. The availability of substituted compliance is subject to the CPO meeting several conditions. Specifically, to elect substituted compliance, a CPO of a RIC:

- must file a notice of use of the substituted compliance regime with the National Futures Association (“NFA”);
- will be required to file financial statements prepared for the RIC under SEC Requirements with the NFA; and
- if the RIC has less than three years of operating history, will be required to disclose the past performance of all accounts and pools managed by the CPO that have substantially similar investment objectives, policies and strategies to those of the RIC.

Under this substituted compliance framework, CPOs of RICs may choose to fully comply with applicable Part 4 requirements *and* SEC Requirements, or they may elect to rely on substituted compliance for those Part 4 requirements that the CFTC in the final harmonization rules has determined to be “designed to achieve substantially similar goals” as the analogous SEC Requirement. However, a CPO that elects to rely on substituted compliance, but that fails to comply with the applicable SEC Requirements, will be in violation of its obligations under Part 4 and subject to enforcement action by the CFTC.

### Disclosure Requirements

Part 4 of the CFTC's Regulations requires a CPO, with respect to each commodity pool it operates, to provide a disclosure document containing specified information about the pool to prospective and existing participants of the pool. Part 4 also specifies requirements for updates to the disclosure document and requires the document to be submitted to the NFA for review before it is provided to prospective or existing pool participants. The final harmonization rules provide for substituted compliance for some, but not all, of these requirements.

#### *Contents of Disclosure Documents*

CFTC Regulation 4.24 prescribes specific and detailed disclosures that must be included in a commodity pool disclosure document.

**Standard Cautionary Statement.** Regulation 4.24(a) requires a CPO to prominently display on the cover page of a commodity pool's disclosure document a standard cautionary statement noting that the CFTC has not passed upon the merits of participating in the pool or assessed the

#### Substituted Compliance

- A CPO of a RIC may elect to comply with some Part 4 obligations through “substituted compliance” with applicable SEC Requirements.
- CPOs of RICs seeking to rely on substituted compliance must electronically file a notice of use of the substituted compliance regime with the NFA.
- Failure to comply with the applicable SEC Requirements by a CPO of a RIC that elects substituted compliance will be deemed to be a violation of the relevant CFTC Regulations and could subject the CPO to enforcement action by the CFTC..

**Two Acceptable Forms of the Standard Cautionary Statement:**

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

adequacy of the disclosure document. The harmonization rules provide that, because this statement performs a similar function to the cautionary statement required by the SEC under Rule 481(b)(1) of the 1933 Act, a CPO of a RIC may comply with the requirements as set out in that Rule, provided that the CFTC is mentioned together with the SEC in such cautionary statement. Two acceptable forms of this statement, as set out in the harmonization rules, are included in the sidebar.

**Risk Disclosure Statement.** Regulation 4.24(b)(1) requires a CPO to include in a commodity pool's disclosure document a standard risk disclosure statement relating to the general risks of investing in a commodity pool and in commodity interests. This standard disclosure is provided in the text of the Regulation. The harmonization rules allow the CPO of a RIC to substitute compliance with SEC Requirements for risk disclosure for the Regulation 4.24(b)(1) risk disclosure statement.

**Disclosure of Principal Risk Factors.** Regulation 4.24(g) requires a CPO to disclose the principal risk factors applicable to a commodity pool in the pool's disclosure document. On the basis that a RIC is required to disclose its principal risk factors under Form N-1A (for open-end investment companies) or Form N-2 (for closed-end investment companies), a CPO of a RIC may substitute compliance with the risk disclosure requirements of Form N-1A or N-2, as applicable, including any applicable SEC guidance, for compliance with Regulation 4.24(g).

The Guidance Update reiterates prior SEC guidance on the disclosure of risks associated with investments in derivatives, including commodity interests. According to the Guidance Update, disclosure of a RIC's principal risks should be specifically tailored to the use of derivatives by the RIC, taking into account the type and extent of derivatives used as well as the purpose for using derivatives. The staff of the Division of Investment Management (the "IM Staff"), according to the Guidance Update, expects that RICs that make use of derivatives will address the associated risks (such as volatility, leverage, liquidity and counterparty risk) in their disclosure documents, where such risks are material to investors. Risks associated with investment strategies that are not principal strategies should be disclosed in a RIC's statement of additional information, according to the Guidance Update.

**Break-Even Point and Fee Disclosure.** A CPO is required by Regulation 4.24(d)(5) to disclose to prospective commodity pool participants the "break-even point" for the commodity pool, which is the amount of profit that the pool must realize in its first year to equal all fees and expenses, such that a participant would be able to recoup its initial investment. Regulation 4.24(i) requires a CPO to provide in the disclosure document a complete description of each fee, commission and other expense that the CPO knows has been incurred or expects to be incurred. The harmonization rules permit substituted compliance with SEC Requirements for fee disclosures under Forms N-1A and N-2, as applicable, in lieu of compliance with Regulations 4.24(d)(5) and 4.24(i).

**Past Performance Disclosure.** Regulation 4.24(n) and 4.25 contain detailed requirements for CPOs regarding the disclosure of past performance of a commodity pool and of each other pool or account

managed by the CPO. The harmonization rules generally provide for substituted compliance with applicable SEC Requirements, in particular Forms N-1A and N-2, as applicable.

However, under new Regulation 4.12(c)(3)(i), a CPO of a RIC that has less than three years of operating history must include in the RIC's disclosure document the past performance of each pool or account operated by the CPO that has substantially similar investment objectives, policies and strategies as the RIC.

**Past Performance Disclosure for CPOs of RICs that Have Less than Three Years of Operating History**

To rely on substituted compliance, a CPO of a RIC that has less than three years of operating history must disclose the past performance of all accounts and pools managed by the CPO that have investment objectives, policies and strategies substantially similar to those of the RIC.

The Guidance Update reiterates the view of the IM Staff that, while not required by Form N-1A or Form N-2, as relevant, it is permissible to include such past performance disclosure in a RIC's prospectus for funds and accounts that have substantially similar investment objectives, policies and strategies to the offered fund. However, according to the Guidance Update, such past performance disclosure must not be presented in a misleading manner and must not impair an understanding of the disclosure required by Form N-1A or Form N-2, as applicable, including an understanding of the offered fund's own past performance. The IM Staff, according to the Guidance Update, expects RICs that include past performance information for other funds or accounts will do so for all funds or accounts that are substantially similar to the offered fund. The performance of other funds or accounts with substantially similar investment objectives, policies and strategies should not be excluded, according to the Guidance Update, if such exclusion would result in materially higher or more favorable performance disclosure. Furthermore, according to the Guidance Update, RICs should only exclude the past performance disclosure of funds or accounts with substantially similar investment objectives, policies and strategies where such exclusion would not cause the performance disclosure to be materially misleading.

***Review of and Updates to Disclosure Documents***

Prior to the harmonization rules, CFTC Regulation 4.26(a)(2) required CPOs to use commodity pool disclosure documents dated no more than nine months prior to their use. As discussed below, the harmonization rules amend Regulation 4.26(a) to permit CPOs to use a disclosure document for up to 12 months, rather than nine months, for all types of commodity pools, including RICs.

However, given that under SEC Requirements an open-end RIC may use a disclosure document for up to 16 months after its last annual update, the harmonization rules allow the CPO of a RIC to conduct the annual update in accordance with SEC Requirements instead of updating the RIC's disclosure document every 12 months. Thus, the CPO of an open-end RIC will not be required to comply with the new Regulation 4.26(a) requirement that its disclosure documents be dated no more than 12 months prior to the date of use, if the RIC is in compliance with the 16-month period under SEC Requirements.

Regulation 4.26(c) requires a CPO to file an update to correct an inaccuracy in a commodity pool's disclosure document within 21 days of the date of discovery of a material inaccuracy therein. Recognizing that SEC Requirements prohibit the offer or sale of shares of a RIC by means of a

materially misleading prospectus, the harmonization rules allow for substituted compliance with SEC Requirements in lieu of compliance with the Regulation 4.26(c) filing requirement.

### ***NFA Review of Disclosure Documents***

Regulation 4.26(d) requires a CPO to submit commodity pool disclosure documents, including upon material amendment of the documents, to the NFA for its approval prior to distributing them to pool participants. The harmonization rules provide for substituted compliance with Regulation 4.26(d), such that, although a RIC's disclosure documents must be made available to the NFA during its examination of the CPO, the CPO of a RIC will not be required to file the disclosure documents with the NFA, so long as the RIC complies with applicable SEC Requirements. RIC disclosure documents filed with the SEC are not subject to NFA approval.

### ***Disclosure Document Delivery***

CFTC Regulation 4.21 requires a CPO to deliver a disclosure document containing specified information about a commodity pool to each participant in the pool. The final harmonization rules provide that a CPO of a RIC will be in compliance with Regulation 4.21 if it complies with SEC Requirements relating to delivery of a RIC's summary prospectus, prospectus, and other disclosure delivery obligations.

In addition, prior to the harmonization rules, CPOs were required by Regulation 4.21 to obtain a signed acknowledgment of receipt of the disclosure document from each pool participant prior to accepting funds from the participant. As discussed below, the CFTC has amended Regulation 4.21 to remove this requirement for CPOs for all commodity pools, including RICs.

### **Financial Reporting**

Under CFTC Regulation 4.22, a CPO is required to distribute periodic account statements to each participant in a pool. For commodity pools that have more than \$500,000 in investments, account statements must be distributed monthly. In contrast, under SEC Requirements, RICs are required to furnish annual and semi-annual reports (including financials) to investors and to file such reports and quarterly schedules of portfolio holdings with the SEC.

The final harmonization rules amend CFTC Regulation 4.12 to provide for conditional substituted compliance for the account statement distribution requirements of CFTC Regulations 4.22(a) and (b). To rely on substituted compliance for these requirements, a CPO must (i) make the current NAV per share of the pool available to pool participants, (ii) clearly disclose that the NAV will be readily accessible online or otherwise made available to pool participants and disclose the website address or other means by which such information may be accessed and (iii) furnish semi-annual and annual reports to pool participants, and file periodic reports with the SEC, in accordance with SEC Requirements.

The final harmonization rules do not modify the requirement under Regulation 4.22(c), applicable to all CPOs, that requires a CPO to file

annual financial statements with the NFA. However, the rules provide that a CPO of a RIC will be able to file with the NFA the same financial statements prepared for the RIC under SEC Requirements.

### **Books and Records**

Prior to the final harmonization rules, CFTC Regulations required a CPO to maintain required books and records at its main business office and make them available for inspection by pool participants at their request.

The final harmonization rules amend CFTC Regulation 4.23 to permit all CPOs, including CPOs of RICs, to hire certain types of third-party service providers to maintain required books and records on their behalf, subject to certain notice requirements. The types of service providers that may be used and the notice requirements are discussed below, in the section describing relief available to CPOs with respect to all types of commodity pools.

CFTC Regulation 4.23(a)(4) requires a CPO to maintain at its main business office a ledger or other form of record for each pool participant setting forth the participant's name and address and recording all funds distributed to or received from the participant. The final harmonization release notes that most RIC shares are held through intermediaries or in omnibus accounts and that records of investors are normally kept by a RIC's transfer agent. Given this practice, the final rules permit CPOs of RICs to comply with Regulation 4.23(a)(4) by having a transfer agent or a financial intermediary maintain such records in the form required by Regulation 4.23(a)(4).

The final harmonization rules also amend CFTC Regulation 4.12 to exempt CPOs of RICs from the obligation to make the RICs' books and records available to pool participants for copying or inspection.

### **Requirement to File Form CPO-PQR for RICs**

In February 2012, the CFTC deferred, pending completion of the harmonization rulemaking, the requirement that CPOs of RICs comply with CFTC Regulation 4.27, which requires CPOs of commodity pools to file reports with the CFTC similar to those required for private funds under the SEC's Form PF. Under the harmonization rules, CPOs of RICs will be required to commence reporting on Form CPO-PQR with respect to the period ending December 31, 2013.

### **Controlled Foreign Corporations**

In the harmonization release, the CFTC reiterates its view that an operator of a controlled foreign corporation (a "CFC") owned by a RIC may be required to register as a CPO, even where the adviser of the RIC is excluded from the requirement to register as a CPO. The final harmonization rules provide, however, that the CPO of a CFC is not required to prepare a separate disclosure document for the CFC if the parent RIC's Form N-1A or N-2, as relevant, contains appropriate investment strategy and principal risk factor disclosure pertaining to the CFC.

Although the harmonization rules do not clearly address whether a CFC would need to file separate financial statements from its parent RIC with the NFA for purposes of CFTC Regulation 4.22(c), the CFTC staff has since provided no-action relief from the requirement that the CFC file separate financial statements with the NFA. In that no-action letter,<sup>3</sup> the CFTC staff also provided that a CPO would not need to separately file Form CPO-PQR for a CFC under CFTC Regulation 4.27. The relief provided in this no-action letter is subject to several conditions, including that the CPO claim the relief available under the letter by submitting an email to the CFTC staff.

#### Part 4 Amendments Applicable to All CPOs

- All CPOs are permitted to use commodity pool disclosure documents for up to 12 months. Prior to the final harmonization rules, CPOs were permitted to use the disclosure document for nine months.
- The CFTC has rescinded the requirement for CPOs to obtain a signed acknowledgment of receipt of disclosure documents from prospective pool participants.
- CPOs are permitted to have their books and records maintained by certain third-party service providers and not only at the CPO's main office.

## Relief for CPOs for All Commodity Pools

The final harmonization rules amend certain provisions of Part 4 of the CFTC Regulations that are applicable to CPOs for all types of commodity pools, not limited to RICs.

### Disclosure Documents

As discussed above, the CFTC has eliminated the requirement under Regulation 4.21(b) for a CPO to obtain a signed acknowledgment of receipt of disclosure documents from all prospective participants in a pool. Furthermore, all CPOs will be permitted to use disclosure documents for up to 12 months.

### Books and Records

CFTC Regulations 4.7(b)(4) and 4.23 are amended to permit CPOs to use certain third-party service providers to maintain their books and records for all types of commodity pools. Prior to the final harmonization rules, a CPO was required to maintain all books and records required by CFTC Regulations at the CPO's main business office. Under amended Regulations 4.7(b)(4) and 4.23, a CPO's books and records may be maintained by "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." While the harmonization rules provide some relief from the requirement for a CPO to maintain required books and records at its main business office, the rules do not appear to contemplate required records being maintained at the office of a subadviser or a commodity trading advisor to a commodity pool or with a professional records storage company. Based on discussions between the CFTC staff and the Investment Company Institute (the "ICI") it appears that the CFTC may provide future relief to broaden the list of persons who may maintain books and records on behalf of a CPO.

A CPO wishing to have its books and records maintained by a third-party service provider must, by the later of the time of its registration with the

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<sup>3</sup> CFTC Letter No. 13-51 (Sept. 5, 2013) available [here](#).



CFTC or delegation of its recordkeeping obligations to a service provider, file a statement with the CFTC (i) identifying the person(s) who will be keeping books and records on behalf of the CPO, (ii) identifying a contact person at each service provider keeping books and records on behalf of the CPO, (iii) specifying which books and records will be kept by the service provider, and (iv) containing specified representations from the CPO including, among others, that the CPO will make the books and records available for inspection at the CPO's main business office within 48 hours after a request by the CFTC (or within 72 hours for books and records maintained outside of the United States). A CPO delegating its recordkeeping responsibilities must include in the pool's disclosure document the location of the pool's books and records and must amend its Form 7-R to update the location where the books and records are kept.

**Statement from Third-Party Service Providers Maintaining Books and Records in Lieu of CPOs:**

A CPO that elects to have a third-party service provider maintain books and records on its behalf must file with the NFA a statement from each such service provider in which the service provider:

- acknowledges that the CPO intends that the service provider maintains the required pool books and records;
- agrees to maintain such books and records in accordance with CFTC Regulation 1.31; and
- agrees to keep such books and records open to inspection by representatives of the CFTC or the U.S. Department of Justice, in accordance with CFTC Regulation 1.31, and to make such books and records available to pool participants as required by CFTC Regulation 4.23.

Additionally, a CPO wishing to have its books and records maintained by a third-party service provider must file with the NFA a statement containing specified agreements from each third-party service provider. The acknowledgments and agreements that must be included in such a statement are included in the sidebar.

## Compliance and Effective Dates

The publication of the final harmonization rules in the *Federal Register* on August 22, 2013 triggered a 60-day conditional compliance date provided by the CFTC in adopting amendments to Regulation 4.5 in 2012 (the “**60-day conditional compliance date**”),<sup>4</sup> requiring compliance 60 days following the effective date for the specific requirement. On August 28, 2013, the ICI sent a letter (the “**ICI Letter**”) to the CFTC’s Division of Swap Dealer and Intermediary Oversight which, among other things, seeks formal confirmation of specific compliance dates. As of the date of publication of this memorandum, the CFTC had not yet responded to the ICI Letter and the compliance dates noted below remain subject to the CFTC’s response and confirmation.

The harmonization rules relating to substituted compliance and obligations for CPOs of RICs became effective on August 22, 2013, except for the related performance disclosure requirement under Regulation 4.12(c)(3)(i) for CPOs of RICs that have less than three years of operating history. That requirement will become effective on September 23, 2013 and, pursuant to the 60-day conditional compliance date, compliance with that requirement will be required on or before November 22, 2013. Therefore, a CPO of a RIC formed on or after November 22, 2013 will be required to comply with Regulation 4.12(c)(3)(i) when the RIC files its initial registration statement. The CPO of an existing RIC will be required to comply with Regulation 4.12(c)(3)(i) when filing the first post-effective annual updating amendment

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<sup>4</sup> 77 Fed. Reg. 11252, 11260 (Feb. 24, 2012).

to a registration statement (for open-end RICs), or the first updated registration statement (for closed-end RICs), to be filed on or after November 22, 2013.

Pursuant to the 60-day conditional compliance date, CPOs of RICs seeking to rely on the exemptions provided under CFTC Regulation 4.12(c)(3)(ii) and (iii) will be required to file with the NFA the notice required by Regulation 4.12(d) and to otherwise comply with the conditions to those exemptions, on or before October 21, 2013.

The effective date for the amendments that permit CPOs to maintain books and records through third-party service providers and those that permit the use of a disclosure document for up to 12 months become effective on September 23, 2013. Pursuant to the 60-day conditional compliance date, CPOs of RICs must be in compliance with the amended Regulation 4.23 recordkeeping requirements, including the notice-filing requirements, on or before November 22, 2013.

The final harmonization rules require that CPOs of RICs begin initial reporting on Form CPO-PQR pursuant to CFTC Regulation 4.27. The first filing would be required with respect to the period ending December 31, 2013 and must be filed within the time periods specified in the instructions to Form CPO-PQR.

- ▶ [See a copy of the CFTC's final rules](#)

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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