The following is a summary of select developments in investment management regulation during the third quarter of 2013.

CFIC AND SEC GUIDANCE FOR REGISTERED INVESTMENT ADVISERS THAT ARE COMMODITY POOL OPERATORS

CFIC Harmonization Rules for CPOs of Registered Investment Companies

On August 13, 2013, the Commodity Futures Trading Commission (CFIC) issued a final rule (Final Rule) that amends Part 4 of CFIC Regulations applicable to commodity pool operators (CPOs). The most anticipated provisions of the Final Rule, commonly referred to as the “Harmonization Rules,” set forth compliance obligations for registered investment companies (RICs) whose advisers are required to register as CPOs due to recent amendments to Rule 4.5 under Part 4 of CFIC Regulations. Because these RICs are subject to regulation by the CFIC in addition to the U.S. Securities and Exchange Commission (SEC), industry commentators raised concerns that dually registered RICs might be subject to duplicative, inconsistent, and possibly conflicting, disclosure, reporting and recordkeeping requirements if required to comply with both the CFIC and SEC regimes. As amended, sections of Part 4 applicable to RIC CPOs harmonize CFIC compliance obligations with those of the SEC to facilitate compliance with both regimes, while maintaining the regulatory objectives of Part 4 of CFIC regulations. In addition to the Harmonization Rules, the Final Rule includes amendments to sections of Part 4 applicable to all CPOs that relax certain administrative obligations that CPOs previously were required to meet.

Registered Investment Company CPOs. The Harmonization Rules establish a substitution compliance election that gives RIC CPOs the option to meet certain CFIC disclosure, reporting, and recordkeeping requirements by complying with or “substituting” the analogous SEC requirements to which such RICs are already subject. RIC CPOs may
choose to comply fully with both applicable Part 4 requirements and SEC requirements or substitute compliance with SEC requirements.

RIC CPOs electing substitution compliance must:

- file with the National Futures Association (NFA): (1) a notice of intent to use substituted compliance; and (2) a RIC’s annual report, including audited financial statements prepared in connection with its SEC reporting obligations;
- add CFTC required disclosure to the front page legend of the RIC’s prospectus; and
- for a RIC with less than a three-year operating history, disclose in the RIC’s prospectus the performance of all other accounts and pools that are managed by the CPO and that have investment objectives, policies and strategies substantially similar to those of the RIC.

All CPOs. The amendments to the sections of Part 4 applicable to all CPOs allow CPOs to:

- use third-party recordkeepers if they file with the NFA a Notice of Intent to use a third-party recordkeeper that includes information related to the recordkeeping arrangement and representations from the third-party recordkeeper;
- avoid Part 4’s monthly account statement delivery requirement if the CPO makes the pool’s daily net asset value publicly available to investors and discloses on the CPO’s website how the information may be accessed; and
- update their disclosure documents on a 12-month basis instead of a 9-month basis.

The Final Rule also eliminates the Part 4 requirement that CPOs obtain executed acknowledgments when disclosure documents are delivered to pool participants.
The Final Rule became effective on August 22, 2013, except for the disclosure exemptions and third-party recordkeeping amendment provisions, which become effective on Sept 23, 2013.

**Certain Compliance Dates.** CPOs should be aware of the timing of certain compliance filings triggered by publication of the Final Rule:

- RIC CPOs relying on the substitute compliance election must file with the NFA a notice that the CPO intends to use the “substituted compliance” regime, by October 21, 2013 and satisfy the disclosure requirements in connection with initial registration or annual post-effective amendment filings on or after November 22, 2013.

- RIC CPOs become subject to Form CPO-PQR filing requirements beginning October 21, 2013, which means that existing RIC CPOs will be required to make their initial filings with respect to the reporting period ending December 31, 2013.

- CPOs planning to use third-party recordkeepers must file with the NFA the notice of the election to use a third-party recordkeeper no later than November 22, 2013.

**SEC Compliance Guidance for RICs that Invest in Commodity Interests**

On the same day as the CFTC’s release of the Harmonization Rules, the Staff of the SEC’s Division of Investment Management (IM Staff) published Guidance Update No. 2013-05 summarizing the IM Staff’s views regarding certain disclosure and compliance matters relevant to RICs that invest in commodity interests. The IM Staff expects the guidance to facilitate compliance with SEC and CFTC disclosure and reporting requirements, including the preparation of disclosure filings and the consideration of compliance issues.

With respect to disclosure, the IM Staff generally reaffirms past SEC guidance on the disclosure of risks associated with investments in derivatives and suggests that RICs assess the accuracy and completeness of their disclosure. In addition, the IM Staff offers, among other things, the following recommendations in key areas:
- **Disclosure of derivatives and associated risk**: RICs must adequately disclose the risks associated with investments in commodity interests, which includes providing: (1) specifically tailored disclosure of principal investment strategies based on how a RIC expects to be managed and addresses those strategies that the RIC expects to be the most important means of achieving its objectives and that it anticipates will have a significant effect on its performance; (2) specifically tailored principal risks disclosure based on the types of derivatives used by the RIC, the extent of their use, and the purpose for using derivatives transactions; and (3) a description of the purpose that the derivatives are intended to serve in the portfolio and the extent to which derivatives are expected to be used.

- **Performance presentations**: A RIC that includes the performance of other funds or private accounts managed by the fund adviser in its registration statement should generally include the performance of all other funds and private accounts managed by the adviser that have investment objectives, policies, and strategies substantially similar to those of the fund.

- **Legend requirement**: A RIC that invests in commodity interests may include a statement in the registration statement legend required by Rule 481 under the Securities Act of 1933 indicating that the CFTC has not approved or disapproved of the securities or passed upon the accuracy or adequacy of the disclosure in the prospectus.

The IM Staff also emphasizes the importance of effective RIC and adviser policies and procedures in the effective management of the risks associated with the use of commodity interest to implement fund objectives and policies.

In a closing note, the IM Staff reminds RICs and advisers that the SEC recently created the Risk and Examinations Office within the Division of Investment Management that is responsible for analyzing and monitoring the risk management activities of investment advisers, investment companies, and the investment management industry as well as new products. The IM Staff further notes that this group has already started to work closely with the SEC’s Office of Compliance.
Inspections and Examinations to make onsite visits to investment management firms. According to the IM Staff, such visits are “designed to increase the SEC staff’s understanding of firms’ risk management activities, including risk management activities related to commodity interests and other derivatives, generate an active dialogue between the staff and firms on key risk and other issues facing firms and the industry, and help inform policy and the examination process.”

**REPO RISK MANAGEMENT RECOMMENDATIONS**

In Guidance Update No. 2013-03 released on July 17, 2013, the IM Staff focuses on legal and operational considerations for managing the risks associated with the use of tri-party repurchase agreements (Repos). This new guidance comes in response to concerns expressed by the Financial Stability Oversight Council in its 2013 Annual Report over money market fund exposure to Repo counterparty risk. In this Guidance Update, the IM Staff encourages advisers to consider the risks they could face if a repo counterparty defaults, noting that such a default could create adverse consequences for fund shareholders. The IM Staff also urges advisers to engage in advance planning in preparation for a default.

Among other things, the IM Staff suggests that advisers consider the following risk management practices:

- Review the master repurchase agreements and related documentation to consider any specified Repo default procedures.

- Review operational aspects of managing a Repo default.

- To the extent possible, determine whether there are potential legal considerations under the Investment Company Act of 1940, as amended, (40 Act) or otherwise that the fund could consider in advance or will need to evaluate at the time of any Repo default.

While the IM Staff conceded that “it is not practical to expect funds to plan for every contingency that can arise from the default of a tri-party repo portfolio holding,” the IM Staff nevertheless advised that “appropriate advance planning for portfolio defaults may help funds
manage such adverse events more smoothly and lessen the chance that such a default has harmful effects that could have been ameliorated.

SEC BRINGS CHARGES FOR THE FIRST TIME BASED ON MISLEADING A CHIEF COMPLIANCE OFFICER

On August 27, 2013, the SEC announced that it had reached a settlement in the case of a Colorado-based former portfolio manager for violations under the 40 Act and the code of ethics of the advisory firm that employed him. Under the settlement order, the portfolio manager must pay more than $350,000, including disgorgement of $231,169 and a penalty of $100,000, and has been barred from the securities industry for at least five years.

The SEC alleged that the portfolio manager attempted to conceal improper personal trading activities by forging documents, including altering trades in brokerage reports and creating fake pre-clearance request approvals. According to the SEC’s order, the portfolio manager failed to pre-clear or report over 600 securities trades in his personal accounts, at least 91 of which involved securities held or acquired by the funds managed by his firm. In addition, the SEC found that in order to conceal such trades, the portfolio manager falsified quarterly and annual trading reports, and falsely certified his annual compliance with his firm’s code of ethics.

According to the SEC’s press release announcing the settlement, this case marks the first instance in which the SEC has brought charges under Rule 38a-1(c) of the 40 Act for misleading and obstructing a chief compliance officer (CCO). In connection with the announcement, Julie Lutz, Acting Co-Director of the SEC’s Denver Regional Office, stated that “[s]ecurities industry professionals have an obligation to adhere to compliance policies, and they certainly must not interfere with the chief compliance officers who enforce those policies.”
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