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March 10, 2009

CFTC Proposes Amendments to Commodity Pool Operator Periodic and Annual Reporting Requirements

The Commodity Futures Trading Commission (the "CFTC") has proposed for public comment various amendments to its rules governing the periodic and annual reporting requirements applicable to commodity pool operators ("CPOs," each a "CPO"), including both registered CPOs and CPOs who are exempt from registration pursuant to applicable CFTC rules.[1] The proposed amendments are designed to clarify ambiguity in the current rules, simplify the process by which CPOs of funds-of-funds may seek extensions from the annual reporting deadline, streamline the filing procedures and reporting requirements for liquidating pools and codify current industry practice with respect to reporting by CPOs. Comments must be submitted on or before March 26, 2009.

Background

CFTC Rule 4.22(a) generally requires a CPO to distribute monthly account statements within 30 days of the end of the month to investors in each non-exempt commodity pool it operates.[2] The CPO must also provide each such investor with an annual financial report, audited by an independent public accountant, within 90 days of the end of the pool's fiscal year pursuant to Rule 4.22(c), and file such annual report with the National Futures Association ("NFA"), a leading futures industry self-regulatory organization having responsibility for CPOs.[3]

For pools operated pursuant to Rule 4.7, which must be offered exclusively to "qualified eligible persons," as defined therein, a CPO is required to distribute less detailed quarterly account statements to investors, as well as to provide investors, and concurrently file with NFA, a streamlined annual financial report, which is generally required to have been audited by an independent public accountant, within 90 days of the end of the pool's fiscal year.

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[1] 74 Fed. Reg. 8220 (February 24, 2009); at http://cftc.gov/stellent/groups/public/@lrfederalregister/documents/file/e9-3840a.pdf.
[2] Account statements may be distributed quarterly for pools with assets of $500,000 or less.
[3] This deadline is applicable while a pool remains in operation; see <u>infra</u> for a discussion of the deadline for liquidating pools.

The exemptions set forth in Rules 4.13(a)(3) and 4.13(a)(4) do not require distribution of periodic or annual reports to investors, but CPOs who distribute annual reports are currently subject to certain requirements.

Summary and Discussion of Proposed Amendments

Clarifying Information Required to Be Included In Periodic Statements of Rule 4.7 Pools

Rule 4.7(b)(2) currently requires the account statements of a CPO of a Rule 4.7-exempt commodity pool (distributed no less frequently than quarterly) to include: (1) the net asset value of the pool as of the end of the reporting period; (2) the change in net asset value of the pool from the end of the previous reporting period; and (3) the net asset value per outstanding unit of participation in the pool as of the end of the reporting period.

The CFTC has proposed to amend this last requirement to permit a CPO to disclose either the net asset value per outstanding participation unit (as required by the current rule) or the total value of the investor's interest or share in the commodity pool as of the end of the reporting period. This amendment is intended to conform this requirement of Rule 4.7 with the corresponding requirement applicable to CPOs with respect to non-exempt pools under Rule 4.22(a). Moreover, this amendment would permit CPOs of Rule 4.7 exempt pools to limit financial information provided in such periodic statements to the information that is most relevant to a particular investor.

Clarifying Information Required to Be Included In Reports of Series Pools

The CFTC is proposing to amend Rules 4.7(b)(2) and 4.22(a) to specify that the periodic and annual account statements of commodity pools organized as entities with limited liability among their series or classes (sometimes referred to as sub-funds), e.g., a Delaware series limited liability company or an Irish umbrella trust, need only include the information for the relevant series. Funds organized as entities without limited liability among their series or classes must continue to present information for both the pool as a whole and each series or class of ownership interest. This proposal is consistent with the American Institute of Certified Public Accountants' ("AICPA") guidance regarding the presentation of financial statements of such entities in accordance with generally accepted accounting principles ("GAAP").

Streamlining Process for Annual Reporting Deadline Extensions By Fund-of-Funds

Pursuant to Rules 4.7(b)(3) and 4.22(c), CPOs are required to provide pool investors with an annual report within 90 calendar days of the end of the pool's fiscal year, and concurrently file such reports with NFA.

Funds-of-funds may currently extend the due date for distribution of their annual report for up to an additional 60 days (i.e., 150 days following the end of the pool's fiscal year). The current process for claiming an extension pursuant to Rule 4.22(f)(2) requires a CPO to file with NFA the initial extension request notice containing certain specified representations prior to the original due date (i.e., within 90 calendar days of the end of the pool's fiscal year). In subsequent years, the statement containing the specified representations may be filed with NFA as of the previously approved extended date (i.e., concurrently with distribution of the annual report). CPOs of funds-of-funds who cannot meet the 150-day filing deadline under Rule 4.22(f)(2) may request an additional 30-day extension pursuant to Rule 4.22(f)(1) which, in addition to requiring the CPO to make certain specified representations, must be accompanied by a letter from an independent public accountant. CPOs of funds-of-funds who are permitted to distribute unaudited annual financial reports to investors pursuant to Rule 4.7(b)(3) may not currently rely on Rule 4.22(f)(2) and may only request extensions pursuant to Rule 4.22(f)(1).

The CFTC is proposing to lengthen the maximum extension permitted under Rule 4.22(f)(2) from 60 to 90 days (i.e., 180 days after the end of the pool's fiscal year) and to make Rule 4.22(f)(2) available to CPOs of funds-of-funds who are permitted to distribute unaudited annual financial reports to investors pursuant to Rule 4.7(b)(3). In addition, the CFTC is proposing to permit CPOs claiming such relief to make a single initial filing containing the required representations and no longer be required to file statements containing the required representations with NFA in subsequent years concurrently with the distribution of annual reports as of the extended date. CPOs that have filed extension request notices under current Rule 4.22(f)(2) would also be permitted to rely on their previous filings and no longer be required to file subsequent notices with NFA.[4]

This proposal, if adopted, would simplify and streamline the extension process by removing the administrative burden involved in filing subsequent notices with NFA, as well as conforming the CFTC's time frame for the filing of annual reports by funds-of-funds with the time frame prescribed by the Securities and Exchange Commission ("SEC").[5] However, in light of recent enforcement actions by the CFTC imposing substantial fines (ranging from $75,000 to $135,000 per CPO) on CPOs for failure to timely file annual reports after CPOs, in some cases, had requested and received the maximum extension (i.e., 180 days after the end of the fiscal year), certain CPOs of funds-of-funds would undoubtedly prefer having more than 180 days to distribute and file annual reports in cases where any such delay is due to circumstances beyond their control.[6]

Simplifying the Final Annual Report Distributed by Liquidating Pools

Rule 4.22(c) currently requires a CPO of a commodity pool that has ceased operation to distribute a final annual report to pool investors and concurrently file a copy with NFA, within 90 days of the pool's permanent cessation of trading, but in any event no later than 90 days after funds are returned to pool investors. Although not previously included in the language of Rule 4.7, the CFTC staff has interpreted

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4 CPOs would, however, be required to notify NFA if the relevant pool is no longer being operated as a fund-of-funds.

5 Note, however, that SEC rules define a "fund of funds" as a pooled investment vehicle that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person of the pool, its general partner, or its adviser. In contrast, CFTC Rule 4.22(f)(2) requires a pool applying for an extension to be invested in one or more "collective investment vehicles."

6 See http://www.cftc.gov/newsroom/enforcementpressreleases/2008/pr5555-08.html.

the time frame for distribution of a Rule 4.7-exempt pool's final annual report to be identical to the time frame under Rule 4.22(c), and the amendment would codify this view by amending Rule 4.7 to that effect.

Due to confusion created by the reference in Rule 4.22(c) to two possible time frames for filing the final annual report, the CFTC has proposed to specify that the final annual report be filed no later than 90 days after the pool ceases trading. The proposed amendments would permit CPOs who have not distributed the pool's assets to investors to include an estimate of the value of the funds remaining to be distributed and the anticipated time frame for distribution. Upon distribution of the remaining funds to investors, a CPO would be required to notify all investors and NFA that all of the pool's funds have been distributed.

In recognition of the high cost typically borne by the remaining investors in connection with preparing a pool's final annual financial statement, the CFTC has proposed to limit the information required to be included in such final annual financial statement to the information that is most significant to remaining investors. In addition, the proposal would permit CPOs of pools that would otherwise be required to distribute audited annual reports to distribute an <u>unaudited</u> final report upon obtaining written waivers from all of the pool's investors, a position that is consistent with prior relief that the CFTC staff has provided to CPOs on a case-by-case basis.

These proposed amendments, while constructive, would largely codify current staff positions, as noted. It would therefore be preferable if the CFTC would consider providing some additional relief in this area. For example, while distribution of a pool's final annual report at the cessation of trading is appropriate in circumstances involving the liquidation of a pool primarily engaged in trading liquid instruments such as futures contracts, it may not be practical for CPOs or meaningful for investors, for a CPO to distribute a final annual report following the cessation of trading of a pool holding a portfolio consisting of many highly illiquid or difficult to value assets. In such cases, it may be more meaningful for investors to receive the final annual report following the final distribution of funds to investors, <u>i.e.</u>, the liquidation of assets. Moreover, a CPO who intends to distribute an audited final report to pool investors may encounter difficulty obtaining an auditor's certification prior to liquidation of the assets held by the pool, despite the flexibility that would be provided under the amended rule. Given current market conditions, which have resulted in unprecedented illiquidity and valuation issues, including in previously liquid asset classes, it would be beneficial for the CFTC to provide CPOs with the discretion to distribute a streamlined final annual report when a fund ceases trading (as would be provided under the proposed rule), yet retain the flexibility to distribute the final annual report following the distribution of all funds to investors.

Similarly, due to the practical difficulty associated with obtaining written waivers from each investor in a pool, especially for pools with numerous investors, CPOs would benefit from having the ability to obtain investor consent to distribution of an unaudited final report through "negative consent," <u>i.e.</u>, by providing investors with notice of the expected distribution of an unaudited annual report and an opportunity to object to such distribution and require that the CPO distribute an audited report. If a CPO must obtain a written waiver from each investor (as would be required under the proposed rule), a pool's investors may incur the expense of preparing an audited final annual statement because a single inattentive investor with a nominal stake in the pool neglects to respond to a CPO's request for a written waiver.

<u>Codifying Existing Policies Regarding Special Allocations of Ownership Equity, Unrealized Gains and Losses and Investee Funds' Income and Expenses</u>

The CFTC has proposed to codify the following longstanding positions:

- Special allocations of partnership equity from limited partners to the general partner must be recognized in the financial statements in the same reporting period as the net income, interest income, or other basis of computation of the special allocation; classified in the Statement of Operations as either an expense or a special allocation of net income; separately reported in the Statement of Partnership Equity; and deducted in the computation of the GAAP-required disclosures. The CFTC has proposed to codify this position in amended Rule 4.22(e)(2), notwithstanding the additional flexibility provided by the AICPA's Audit and Accounting Guide.

- Realized and unrealized gains and losses on regulated commodities transactions may be combined with realized or unrealized gains and losses, respectively, from non-commodity interest trading, provided that the gains and losses to be combined are part of a related trading strategy; and gains or losses from foreign currency translations and conversions may be included with the related trading strategy, or reported separately. The CFTC is proposing to amend Rule 4.22(e) to that effect.

- Disclosure in annual reports for pools prepared under Rule 4.22(c) or Rule 4.7(b)(3) must contain information on the amounts of income and expenses associated with a pool's investments in investee funds (<u>e.g.</u>, income received from, and fees paid to, investee pools), and identify by name investee funds in which investments exceed five percent of the pool's net assets. The CFTC is proposing amendments to Rule 4.22(c) and Rule 4.7(b)(3) for this purpose.

<u>Use of GAAP</u>

CFTC rules require audited and unaudited periodic and annual financial statements to be presented and computed in accordance with GAAP. The CFTC staff has consistently interpreted this provision to mean GAAP as established in the United States ("U.S. GAAP"). On a case-by-case basis, CFTC staff has, however, provided limited relief from this requirement to CPOs who operate commodity pools organized under the laws of a foreign jurisdiction by permitting the financial statements of such pools to be prepared and presented in accordance with International Financial Reporting Standards ("IFRS"). The CFTC staff has conditioned such relief upon the offshore pool following certain key elements of U.S. GAAP standards, including preparing a condensed Schedule of Investments; reporting special allocations of partnership equity in accordance with CFTC Interpretative Letter 94-3, proposed to be codified in an amendment to Rule 4.22(e)(2) (see above); and, in the event that IFRS would require consolidated financial statements for the pool, adequately reporting results of operations and financial positions specific to each class of the pool's investors. In addition, the CFTC staff has required that a CPO's use of accounting standards other than U.S. GAAP not conflict with any representations made to investors or prospective investors in the pool.

The CFTC is proposing that a CPO be permitted to claim relief to prepare financial statements pursuant to IFRS by filing a notice that includes representations regarding compliance with the foregoing conditions. The proposal would permit a CPO to file a single initial notice for all such pools it operates, which could be relied upon in subsequent years of the operation of such pools. Although the CFTC staff has also provided relief on a case-by-case basis permitting the use of accounting standards established in other jurisdictions, including the United Kingdom, Ireland and Luxembourg, the proposed notice process would apply solely for pools that are following IFRS. CPOs of offshore pools who meet the criteria specified in the proposed amendments, but use accounting standards other than IFRS would continue to seek case-by-case relief from the U.S. GAAP requirement by filing such requests with CFTC staff.

As noted, CFTC rules do not require CPOs of pools operated pursuant to Rule 4.13 to distribute annual (or periodic) reports to their investors. However, if the CPO of a pool operated pursuant to Rule 4.13 elects to distribute an annual report to investors in the pool, CFTC rules currently require the report to be presented and computed in accordance with GAAP, which has been interpreted to mean U.S. GAAP (see above), and, if the report is certified by an independent public accountant, for it to be certified in accordance with Rule 1.16.

The CFTC is proposing to eliminate these restrictions on the presentation and manner of certifying annual reports for pools operated pursuant to Rule 4.13. The CFTC correctly reasons that such requirements are not appropriate given that such reports are not required to be prepared or distributed to investors in the first place.

Again, these proposals are generally constructive. For example, the CFTC's proposal to eliminate the requirement that pools operated pursuant to Rule 4.13 prepare annual reports in accordance with U.S. GAAP should reduce the need for such CPOs to seek relief from the U.S. GAAP reporting requirement on a case-by-case basis because many such pools are operated pursuant to Rule 4.13(a)(4). It would be useful for the CFTC to expand the proposed streamlined relief to include annual reports prepared in accordance with the accounting standards of the United Kingdom, Ireland and Luxembourg as well, consistent with prior relief which the CFTC staff has granted on a case-by-case basis.

Updating References to Financial Schedules

The CFTC is proposing to update certain references to financial schedules contained in the periodic and annual reporting provisions of the Part 4 rules to be consistent with current accounting practices. Specifically, the CFTC is proposing to: delete references to the Statement of Changes in Financial Position, which no longer exists; rename the Statement of Income (Loss) as the Statement of Operations; and rename the Statement of Changes in Net Asset Value as the Statement of Changes in Net Assets.

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Authors and Contributors:

New York

David S. Mitchell	+1.212.859.8292	david.mitchell@friedfrank.com
Mark Molle	+1.212.859.8648	mark.molle@friedfrank.com

If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact, or any of the partners in the Fried Frank Asset Management and Private Equity Group listed below.

New York

Lawrence N. Barshay	+1.212.859.8551	lawrence.barshay@friedfrank.com
Jonathan S. Adler	+1.212.859.8662	jonathan.adler@friedfrank.com
John M. Bibona	+1.212.859.8539	john.bibona@friedfrank.com
Jessica Forbes	+1.212.859.8558	jessica.forbes@friedfrank.com
Terrance J. O'Malley	+1.212.859.8402	terrance.omalley@friedfrank.com
Kenneth I. Rosh	+1.212.859.8535	kenneth.rosh@friedfrank.com

Washington, DC

Richard I. Ansbacher	+1.202.639.7065	richard.ansbacher@friedfrank.com
Walid Khuri	+1.202.639.7013	walid.khuri@friedfrank.com
Bradford R. Lucas	+1.202.639.7483	brad.lucas@friedfrank.com
Andrew P. Varney	+1.202.639.7032	andrew.varney@friedfrank.com

Hong Kong

Richard A. Steinwurtzel	+852.3760.3691	richard.steinwurtzel@friedfrank.com

Fried, Frank, Harris, Shriver & Jacobson LLP

New York
One New York Plaza
New York, NY 10004
Tel: +1.212.859.8000
Fax: +1.212.859.4000

Washington, DC
1001 Pennsylvania Avenue, NW
Washington, DC 20004
Tel: +1.202.639.7000
Fax: +1.202.639.7003

Frankfurt
Taunusanlage 18
60325 Frankfurt am Main
Tel: +49.69.870.030.00
Fax: +49.69.870.030.555

Hong Kong
In association with
Huen Wong & Co.
9th Floor, Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
Tel: +852.3760.3600
Fax: +852.3760.3611

Shanghai
40th Floor, Park Place
1601 Nanjing Road West
Shanghai 200040
Tel: +86.21.6122.5500
Fax: +86.21.6122.5588

Fried, Frank, Harris, Shriver & Jacobson (London) LLP

London
99 City Road
London EC1Y 1AX
Tel: +44.20.7972.9600
Fax: +44.20.7972.9602

Fried, Frank, Harris, Shriver & Jacobson (Europe)

Paris
65-67, avenue des Champs Elysées
75008 Paris
Tel: +33.140.62.22.00
Fax: +33.140.62.22.29