

MEMO# 24947

February 4, 2011

CFTC Proposes to Narrow Rule 4.5 Exclusion for Registered Investment Companies; Conference Call on February 10

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 9-11
ETF ADVISORY COMMITTEE No. 14-11
SEC RULES COMMITTEE No. 14-11
SMALL FUNDS COMMITTEE No. 8-11 RE: CFTC PROPOSES TO NARROW RULE 4.5 EXCLUSION
FOR REGISTERED INVESTMENT COMPANIES; CONFERENCE CALL ON FEBRUARY 10

The Commodity Futures Trading Commission (“CFTC”) has proposed to revise or rescind several of its rules, as well as adopt new disclosure requirements, in an effort to “more effectively oversee its market participants and manage the risks that such participants pose to the markets.” [\[1\]](#) Among the affected rules is Rule 4.5, under which a registered investment company (“fund”) may claim an exclusion from regulation as a commodity pool operator (“CPO”). The proposed amendments would condition this exclusion on a fund’s adherence to certain trading and marketing restrictions applicable to its positions in commodity futures, commodity options, and swaps. The proposed amendments to Rule 4.5 and other relevant aspects of the CFTC proposal are briefly summarized below. [\[2\]](#)

We will hold a conference call to discuss the CFTC proposal and ICI’s comment letter on Thursday, February 10 at 2:00 pm ET. The dial-in number for the call is 888/323-9789 and the passcode is 53355. If you plan to participate, please RSVP to Gwen Kelly via email (gwen.kelly@ici.org) by noon on February 10. If you cannot participate, please provide comments on the proposal to Rachel Graham by phone (202/326-5819) or email (rgraham@ici.org) before the call if possible.

Proposed Amendments to Rule 4.5

Current Rule 4.5 excludes certain “otherwise regulated entities,” including funds, from CPO regulation if the entity files a notice of eligibility with the National Futures Association (“NFA”) that includes certain representations. Last fall, the CFTC published for comment an

NFA petition for rulemaking that asked the CFTC to narrow significantly the Rule 4.5 exclusion as applied to funds, including by conditioning eligibility for the exclusion on compliance with certain trading and marketing restrictions. [3] The CFTC now proposes amendments to Rule 4.5 that not only incorporate the trading and marketing restrictions suggested in the NFA petition but also extend those restrictions to a fund's positions in swaps. [4] The proposed restrictions are as follows:

- **Trading Restriction:** A fund would be required to represent, in its notice of eligibility for the exclusion, that it will use commodity futures, commodity options or swaps solely for "bona fide hedging purposes." It may, however, represent that it will hold a limited amount of such instruments not for bona fide hedging purposes, generally subject to representations that the aggregate initial margin and premiums required to establish those positions will not exceed five percent of the liquidation value of the fund's portfolio. Any instruments held for non-hedging purposes would need to be held directly by the fund as the "qualifying entity," and not through a wholly-owned subsidiary.
- **Marketing Restriction:** The fund would be required to represent that it will not be, and has not been, marketing participations in the fund to the public as or in a commodity pool or otherwise as or in a vehicle for trading in (or otherwise seeking investment exposure to) the commodity futures, commodity options, or swaps markets.

Funds unable to comply with these restrictions would be required to register with the CFTC as CPOs and comply with, among other requirements, part 4 of the CFTC's regulations. [5]

According to the Notice, the CFTC is seeking to "stop the practice of registered investment companies offering futures-only investment products without Commission oversight" and believes that "NFA's proposed language is an appropriate point at which to begin discussions regarding the Commission's concerns." At the same time, the CFTC is "cognizant of the fact that [the structure of funds] may result in operational difficulties with respect to compliance with part 4" of its regulations. The Notice contains several questions, derived from comments received with respect to the NFA's petition, that are intended to "solicit comments regarding what the Commission should consider with respect to the regulation of [funds]."

Request for Comment on Proposed Amendments to Rule 4.5

- Several commenters to NFA's petition have suggested that the marketing strategies used by entities claiming relief under Rule 4.5 would be prohibited under NFA's proposal. Specifically, it has been argued that marketing these funds under proposed Rule 4.5 would be impossible, or nearly impossible, as it would be cost prohibitive. The Commission solicits comments on how these marketing strategies would be affected by the proposed rule change. Specifically, should the proposed restriction on marketing as a commodity pool or as a vehicle for providing exposure to commodity interests be broader or more narrow?
- It has been suggested that funds operated pursuant to relief under Rule 4.5 are now following numerous trading strategies, including "life cycle" fund strategies, which are set to maximize trading successes for certain trading periods, or horizons. The Commission seeks comment on the differential impact the proposed rulemaking would have on the various trading strategies implemented by funds operated under Rule 4.5, including which types of funds might be more severely impacted than others, and, if

so, why?

- Some commenters to the NFA petition have suggested that the term "marketing" needs to be clarified. What considerations should be made with respect to such a definition? Further, what specific areas related to marketing are most problematic and, if so, why?
- Commenters to the NFA petition have suggested that the changes to Rule 4.5 would result in direct conflicts with SEC regulations relating to registered investment companies. Please detail which rules and regulations are in conflict, and indicate how these could be best addressed by the two Commissions.
- Is a limit of five percent of the liquidation value of the portfolio attributable to non-bona fide hedging purposes the appropriate threshold? Should a higher or lower limit apply? Should the calculation of the limit include swaps, or be limited to futures and options? Is a portfolio based criterion appropriate or is there another more effective means for identifying entities that should be registered as CPOs?
- Additionally, the Commission is soliciting comment regarding the implementation of the proposed changes to Rule 4.5. What issues should the Commission consider with respect to the ability of registered investment companies to comply with the disclosure document and reporting delivery requirements; recordkeeping; and related fund performance disclosure requirements under part 4 of the Commission's regulations? How much time will be necessary for entities that have previously claimed exclusion under this section to comply with the proposed changes? Should any entities that have previously claimed exclusion under this section be exempted from compliance with the proposed revisions to Rule 4.5?

Other Relevant Aspects of the Proposal

Annual Filing of Notice of Eligibility

Persons claiming an exclusion from the definition of CPO (including under Rule 4.5) or an exemption from registration as a CPO or CTA would be required to affirm their notice of exclusion or exemption on an annual basis. This would need to be done electronically through the NFA within 30 days of the anniversary of the initial filing date. According to the Notice, failure to comply with the annual requirement would result in a deemed withdrawal of the exclusion or exemption and could result in the initiation of an enforcement action.

Periodic Disclosure by CPOs and CTAs

According to the Notice, the CFTC has concluded that reports currently filed by CFTC registrants "do not provide sufficient information regarding their activities for the Commission to effectively monitor the risks posed by those participants to the commodity futures and derivatives markets." Accordingly, the CFTC is proposing new Forms CRO-PRQ and CTA-PR that would be filed by all registered CPOs and CTAs. These forms would be filed electronically with the NFA, typically on a quarterly basis. To eliminate duplicative filings, certain persons who are dually registered with the CFTC and SEC could satisfy some of their reporting obligations through the filing of new Form PF, which has been jointly proposed by the two Commissions. The amount of information that a CPO or CTA would have to disclose on Forms CPO-PRQ and CTA-PR would vary depending upon both the size of the operator/adviser and the size of the advised pools. The information to be disclosed on these forms is "generally identical" to that being sought on Form PF. [\[6\]](#)

Risk Disclosures Regarding Swap Transactions

The proposal would require that the mandatory Risk Disclosure Statements for CPOs and CTAs include disclosure about certain risks specific to swaps transactions. The Notice states that the CFTC believes such disclosure is necessary to inform pool participants and clients about the potential risks that swaps may have limited liquidity and may be hard to value, and that the significance of these risks should be “appropriately highlighted” by including standardized disclosure at the beginning of the Risk Disclosure Statement. [7]

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endnotes

[1] Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (Jan. 26, 2010) (“Notice”), available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister012611b.pdf>. Comments are due 60 days after publication of the notice in the Federal Register.

[2] This memorandum does not discuss the proposed rescission of Rule 4.13(a)(3) and (a)(4) and certain other aspects of the proposal that are not relevant to registered investment companies.

[3] See Petition of the National Futures Association, Pursuant to Rule 13.2, to the U.S. Commodity Futures Trading Commission to Amend Rule 4.5, 75 Fed. Reg. 56997 (Sept. 17, 2010). For a summary of ICI’s comment letter on the NFA petition, see ICI [Memorandum](#) No. 24625, dated Oct. 18, 2010.

[4] The trading and marketing restrictions suggested in the NFA petition are modeled on provisions that the CFTC eliminated from Rule 4.5 in 2003, but are actually much broader in scope. For further explanation, see Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated Oct. 18, 2010, at 4-6.

[5] Part 4 of the CFTC’s regulations addresses, among other things, disclosure and reporting to pool participants, delivery of disclosure documents, recordkeeping, and performance disclosure.

[6] For further detail, see ICI [Memorandum](#) 24925, dated Jan. 31, 2011 (summarizing the SEC’s proposal on Form PF).

[7] The proposed disclosure language is set forth on pp. 57-58 of the Notice.