

**MEMO# 28029**

April 11, 2014

# ICI Files Comment Letter on NFA Capital and Customer Protection Proposal

[28029]

April 11, 2014

TO: ACCOUNTING/TREASURERS COMMITTEE No. 10-14  
CLOSED-END INVESTMENT COMPANY MEMBERS No. 13-14  
COMPLIANCE MEMBERS No. 8-14  
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 26-14  
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 7-14  
ETF ADVISORY COMMITTEE No. 5-14  
INVESTMENT ADVISER MEMBERS No. 13-14  
SEC RULES MEMBERS No. 14-14  
SMALL FUNDS MEMBERS No. 9-14  
UNIT INVESTMENT TRUST MEMBERS No. 3-14 RE: ICI FILES COMMENT LETTER ON NFA  
CAPITAL AND CUSTOMER PROTECTION PROPOSAL

On April 11, ICI filed a comment letter with National Futures Association (“NFA”), in response to their notice to members (“NTM”) requesting comment on capital requirements for commodity pool operators (“CPOs”) and commodity trading advisors (“CTAs”) and other customer protection measures. [\[1\]](#) The comment letter is attached, and is summarized below.

## **I. CPO/CTA Capital Requirement**

The comment letter explains that the comprehensive regulation to which CPOs and CTAs of registered investment companies (“registered funds”) are subject under the Investment Company Act of 1940 (“Investment Company Act”) and the Investment Advisers Act of 1940 (“Investment Advisers Act”) makes it unnecessary to impose a capital requirement on such CPOs and CTAs. In particular, the registered fund adviser, which also is registered with the Securities and Exchange Commission under the Investment Advisers Act, may not maintain custody of the registered fund’s portfolio assets. Instead, under the Investment Company Act, fund portfolio assets must be held in a custody arrangement meeting the requirements of Section 17(f) of the Investment Company Act and related rules. The letter also discusses other Investment Company Act requirements that serve, among other purposes, to protect the integrity of fund assets, such as the affiliated and joint transaction prohibitions under Section 17 of the Investment Company Act. The letter goes on to explain that requirements with respect to compliance programs provide a further layer of

protection against misappropriation of client assets.

The letter explains that NFA's concern that it is necessary to impose a capital requirement on CPO/CTA members to ensure they have sufficient assets to operate as a going concern is not justified with respect to registered fund CPOs and CTAs. A registered fund's investment adviser, acting as agent, manages the fund's portfolio pursuant to a written contract with the fund that is subject to oversight and annual approval by the fund's board of directors, including a majority of independent directors. If the registered fund's directors determine, in their business judgment, that the adviser does not have the financial capacity to continue to manage the registered fund, they may terminate the adviser's advisory contract and, with shareholder approval, contract with another, financially viable, adviser to manage the fund. Under these circumstances, due to the strict custodial and other protections under the Investment Company Act and the Investment Advisers Act, there would be no financial risk posed to the registered fund, the portfolio assets of which would remain protected at an eligible custodian. [\[2\]](#)

## **II. Other Customer Protection Measures**

The letter explains that, for similar reasons, the customer protection measures NFA proposes are unnecessary for registered fund CPOs and CTAs. It reiterates that registered fund CPOs cannot hold customer assets, and that the requirements of the Investment Company Act ensure that registered fund assets are maintained only with eligible custodians, subject to strict conditions intended to protect fund shareholders. It states that, based on a review of NFA disciplinary actions against CPOs over the past three years involving the improper use of pool assets, it appears that none of them involved a registered fund CPO, and that these actions generally involved outright fraud. The letter asserts that NFA has not raised any concerns about registered fund CPOs with respect to misuse of fund assets, and that the costs of imposing any additional requirements on fund CPOs would be indirectly borne by fund shareholders.

### **A. Independent Third Party Authorization for Disbursement of Pool Funds**

The letter states that it is unnecessary for NFA to require independent third-party authorization of registered fund CPO disbursement of pool assets. Registered funds and their shareholders are well protected against the risk of unauthorized disbursement of fund assets by custody and fidelity bond requirements under the Investment Company Act, as well as the control practices employed by registered funds and their custodians, which the letter explains in detail.

### **B. NAV Valuation and Monthly or Quarterly Reporting**

As a preliminary matter, the letter notes that the CFTC has granted substituted compliance relief to registered fund CPOs with respect to, among other things, account statements required under CFTC Regulation 4.22(a) and (b). Registered fund CPOs, therefore, are not subject to these provisions, and additional customer protections related to them likewise would be inapplicable. The letter nonetheless provides detailed information regarding registered fund regulation, and processes, in this area, including how registered funds calculate their net asset values and the requirements under the Investment Company Act with respect to registered funds' financial reporting.

### **C. Performance Results**

The letter explains that the CFTC has provided substituted compliance relief to registered

fund CPOs with respect to performance reporting under CFTC Regulations 4.24 and 4.25. Registered fund CPOs, therefore, are not subject to these provisions, and additional customer protections related to them likewise would be inapplicable. The letter, nonetheless, provides detailed information regarding registered fund regulation, and processes, in this area, explaining the requirements under the federal securities laws for registered funds' calculation and presentation of performance information; that certain registered fund performance information is audited, or is reviewed by the fund's independent public accountant; and that registered fund promotional materials are subject to requirements for preparation, review and approval under the rules of FINRA .

#### D. Verification of Pool Assets

The letter states that, based on the protections applicable to registered funds under the Investment Company Act and rules, and the periodic reconciliation of registered fund assets to custodian bank records, we believe it is unnecessary for NFA to require a verification system for registered fund assets, as it currently requires for FCMs. The letter notes that NFA has not raised any concerns about registered fund CPOs with respect to verification of pool assets.

#### E. Inactive Members

The letter also addresses NFA's question of whether it should continue to permit inactive CPOs and CTAs to be NFA members. The letter asserts that NFA should permit inactive firms or those firms that are temporarily able to rely on an exclusion or exemption from CPO or CTA registration to remain NFA members. It explains that commodities trading in the pools managed by these CPOs and CTAs may fluctuate, at times making them eligible for an exemption or exclusion from CPO or CTA registration, while at other times requiring them to be registered. It would not be prudent or efficient, however, for these CPOs and CTAs to withdraw their registrations temporarily in favor of an exemption or exclusion, if they thereafter expected to be subject to registration.

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Senior Counsel

Rachel H. Graham  
Senior Associate Counsel

#### [Attachment](#)

#### **endnotes**

[1] NFA Notice to Members I-14-03 (Jan. 23, 2014), available at <http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4377>. See ICI Memorandum No. 27861 (Jan. 24, 2014), available at [http://www.ici.org/my\\_ici/memorandum/memo27861](http://www.ici.org/my_ici/memorandum/memo27861). Comments on the NTM were due by April 15, 2014.

[2] Further, the letter notes that an adviser does not take on the fund's investment risks. The adviser does not own fund assets, and it may not use fund assets to benefit itself or any other client. Investment gains and losses from a fund are solely attributable to that fund, and do not flow through to the adviser.

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