The Asset Management Industry
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INVESTMENT COMPANY INSTITUTE

MEMO# 25070

April 6, 2011

Draft ICI Letter on CFTC Proposal to Narrow Rule 4.5 Exclusion for Funds; April 8 Conference Call

[25070]

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 20-11
DERIVATIVES MARKETS ADVISORY COMMITTEE
ETF ADVISORY COMMITTEE No. 22-11
FIXED-INCOME ADVISORY COMMITTEE No. 30-11
SEC RULES COMMITTEE No. 28-11
SMALL FUNDS COMMITTEE No. 12-11 RE: DRAFT ICI LETTER ON CFTC PROPOSAL TO NARROW RULE 4.5 EXCLUSION FOR FUNDS; APRIL 8 CONFERENCE CALL

As we previously informed you, 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 ICI has prepared a draft comment letter. Background information on the proposal and a summary of the key arguments in our draft letter are provided below.

We will hold a conference call to discuss the draft comment letter on Friday, April 8 at 11 am ET. Due to the letter's length and the complexity of the issues it addresses, the call may last for up to two hours. If you plan to participate, please RSVP to Gwen Kelly (gwen.kelly@ici.org) by the close of business on April 7, and she will provide you with the dial-in information. If you cannot participate, please provide comments to Sarah Bessin (sarah.bessin@ici.org) and Rachel Graham (rgraham@ici.org). Comments are due to the CFTC no later than April 12.

Background—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. [2] The CFTC's proposed amendments to Rule 4.5 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. 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 represent, however, 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 satisfy these restrictions would be subject to CFTC oversight and required to comply with part 4 of the CFTC's regulations. [3] The proposal is silent on the question of exactly who would have to register as a CPO in the case of a fund unable to rely on amended Rule 4.5. As noted below, there is a chance that the CFTC could look to the fund's directors, rather than the adviser, to fulfill this role.

Summary of Key Arguments in Draft Letter

- Adoption of the Proposal is Premature: By its own admission, the CFTC has published what essentially amounts to an advance notice of proposed rulemaking – it notes that the language of its proposal is "an appropriate point at which to begin discussions . . .." The draft letter emphasizes that adopting the proposal without resolving the many critical issues it raises would be premature and that reproposal is necessary under these circumstances.
- Inclusion of Swaps: The CFTC proposal takes language from the NFA's rule petition and broadens it, so that the proposed trading and marketing restrictions would apply not just to a fund's positions in commodity futures and options, but also to its positions in swaps. (It should be noted that the CFTC gained jurisdiction over non-security based swaps as part of the Dodd-Frank Act.) The draft letter explains that the inclusion of swaps has broad implications for a wide variety of funds, which may find it difficult or impossible to meet the limitations proposed by the CFTC. The letter questions the CFTC's rationale for including all swaps in its proposal, regardless of how funds use them. It also emphasizes that application of the proposal to swaps is premature because the CFTC and SEC have not yet adopted rules specifying which swaps will be subject to central clearing and it is still unclear whether foreign

exchange swaps and foreign exchange forwards will be considered “swaps” subject to CFTC oversight.

- Trading Restriction: The proposed five percent limit on positions taken for non-bona fide hedging purposes, especially as it would apply to swaps, futures, and options used for non-speculative purposes, would result in a large number of funds being unable to rely on the Rule 4.5 exclusion. The draft letter argues that (1) the definition of bona fide hedging should be expanded to include positions taken by fund advisers for non-speculative purposes and (2) the five percent threshold should be raised to reflect current margin levels for derivative instruments in which funds invest. The letter notes, however, that it is not possible to comment on what the specific threshold should be until margin levels for centrally-cleared swaps are determined.
- Marketing Restriction: The proposed language seeking to restrict funds’ ability to market themselves as “otherwise seeking investment exposure to” the commodity futures and options markets is phrased broadly and could pick up a wide variety of funds that invest only a portion of their assets in commodities, and not as a primary investment strategy (e.g., asset allocation funds). The draft letter argues that this language is unnecessary and should be eliminated. In addition, the letter requests clarification regarding the scope of the marketing restriction and confirmation that it would not apply to risk and other required disclosures in a fund’s registration statement.
- Registration of Directors as CPOs: Under past guidance provided by the CFTC, it is typically a commodity pool’s general partner, managing member, or directors that register as CPOs. The draft letter requests clarification from the CFTC that if a fund is not eligible to rely on the Rule 4.5 exclusion, the fund’s adviser, rather than the fund itself or its directors, should register as a CPO. The prospect of CPO registration for fund directors, especially independent directors, raises troubling issues. The letter explains that the fund’s adviser is the appropriate entity to perform the CPO role in cases where the fund cannot rely on Rule 4.5, because the adviser is typically responsible for establishing the fund and operating it on a day-to-day basis.
- Use of Wholly Owned Subsidiary Structure: The proposal would require that any instruments held for non-hedging purposes be held directly by the fund as the “qualifying entity,” and not through a wholly owned subsidiary, as funds investing in commodities often do today to avoid adverse tax consequences. The draft letter emphasizes that funds use this subsidiary structure for legitimate tax purposes and not to evade regulation under the Investment Company Act. It recommends that an adviser required to register as a CPO be obligated to make representations regarding availability of the books and records maintained by the fund’s subsidiary, and the subsidiary’s compliance with certain key provisions of the Investment Company Act.
- Areas of Conflict Between SEC and CFTC Regulation: Advisers to funds that would be unable to meet the criteria for exclusion under proposed Rule 4.5 would be subject to both SEC and CFTC regulation, potentially resulting in duplicative regulation in many areas and as conflicting requirements in others, such as those relating to the content of disclosure documents, delivery obligations, presentation of performance data, and operational requirements. The draft letter argues that funds should not be subject to duplicative regulation, that any conflicts between the regulatory requirements should be resolved by the CFTC and SEC, and that any proposed resolution of these issues should be subject to public notice and comment. It includes a lengthy appendix that compares the various areas of duplicative and conflicting regulatory requirements, and offers recommended resolutions in each area.

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Attachment

endnotes

[1] Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (Jan. 26, 2010) ("Release"). For a summary of the CFTC's proposal, see ICI Memorandum 24947, dated Feb. 4, 2011.

[2] 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.

[3] 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.