MUTUAL FUND DIRECTORS FORUM
The FORUM *for* FUND INDEPENDENT DIRECTORS

April 12, 2011

VIA ELECTRONIC FILING

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Proposed Rulemaking Regarding Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations RIN Number 3038-AD30

Dear Mr. Stawick:

The Mutual Fund Directors Forum (the "Forum")[1] appreciates the opportunity to comment on the proposed rulemaking (the "CPO Proposal") by the Commodity Futures Trading Commission ("Commission" or "CFTC") concerning the reinstatement and expansion of commodity pool operator ("CPO") registration and reporting requirements for registered investment companies ("Registered Funds" or "Funds") and private investment companies.[2]

The Forum, an independent, non-profit organization for independent directors of Registered Funds, is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through continuing education and other services, the Forum provides its members with opportunities to share ideas, experiences, and information concerning critical issues facing investment company independent directors today and serves as an independent vehicle through which Forum members can express their views on matters of concern.

---

[1] The Forum's current membership includes over 600 independent directors, representing 86 independent director groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

[2] Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 76 FR 7976 (Feb. 11, 2011) ("Proposing Release").

I. Background – Registered Funds and their Independent Directors

Under the Investment Company Act of 1940 (the "1940 Act"), entities that meet the definition of "investment company" must register with the Securities and Exchange Commission ("SEC"). The definition of "investment company" centers on entities that themselves issue securities and use the proceeds of the public sale of those securities primarily to invest in other securities, including equity and fixed-income securities.

Registered Funds are formed under state law (as Maryland corporations, Delaware statutory trusts, Massachusetts business trusts, *etc.*) and thus have directors or trustees (collectively, "Directors") and officers to carry out their businesses. Typically, the investment adviser creates the Fund and supplies the persons to serve as officers of the Registered Fund, at no direct cost to the Fund. Registered Funds generally do not have their own employees to carry out their businesses but rely on third-party service providers to conduct their day-to day operations. [3] A Fund's primary service provider is the investment adviser, which makes the investment decisions for the Fund. The investment adviser generally recommends and coordinates the day-to-day operations of the other Fund service providers, including administrators, distributors, and transfer agents.

In recognition of the potential conflicts inherent in the structure of Registered Funds, since 1940 Congress has required that a minimum of 40 percent of the Directors of a Registered Fund be persons who are independent of, among others, the investment adviser and its affiliated persons ("Independent Directors").[4] Congress also gave the Independent Directors special functions, including, but not limited to, the annual review and renewal of the written contracts with the Registered Funds' investment advisers, and the annual appointment of independent public accountants for the Funds. Independent Directors serve as "watchdogs" of the interests of the shareholders of Registered Funds by overseeing the services provided to the Fund.

---

[3] An important exception to this practice is the chief compliance officer ("CCO") of a Registered Fund, who must be appointed by the Independent Directors of the Registered Fund ("Independent Directors"). While many Registered Funds use fund assets to pay the CCO, some choose for the CCO to be an employee of, and paid by, the Registered Fund's investment adviser, like the other fund officers.

[4] Section 2(a)(19) of the 1940 Act sets forth the definition of who is eligible to serve as an Independent Director, and is designed to ensure that Independent Directors' interests are aligned with the shareholders of Registered Funds and that Independent Directors are not affiliated with, among others, the Funds' investment advisers or their affiliated persons. Registered Funds often also have interested Directors who are employees of the investment adviser or its affiliated persons and who serve on the board in order to supply the viewpoint of fund management (the adviser). Although the 1940 Act requires only that 40 percent of Directors be "independent," a condition of a number of exemptive rules commonly relied on by Funds requires a majority of the board to be composed of Independent Directors. As a practical matter, most fund boards are composed of at least a majority of Independent Directors and many have chosen to maintain a minimum of 75 percent.

The use of derivatives for Registered Funds is also subject to regulation under the 1940 Act and specific public disclosure requirements under the Securities Act of 1933 (the "1933 Act").[5] Like all other investments and investment strategies, the use of derivatives by Registered Funds also is subject to the oversight of the Independent Directors of these Funds.[6] Investment advisers use derivative instruments for many different purposes, including hedging, equitization, moderating interest rate exposures and managing duration, and to gain exposures to various asset classes and markets. Independent Directors have found that the use of derivative instruments by experienced investment advisers with appropriate infrastructure to manage the investments can serve the best interests of retail investors.

The role of Directors in overseeing their funds' use of derivatives is critical, but is also limited. Notably, as then-SEC Chairman Arthur Levitt stated in a 1994 letter:

> [Directors] have critical oversight responsibilities for their fund's use of derivatives...[i]t is their job to review and approve fund disclosures, and to oversee pricing issues, suitability, trading strategies, accounting questions, and internal controls. [Directors] who authorize the use of derivatives need not micromanage the minutiae of individual derivatives transactions, but they must exercise knowledgeable and meaningful oversight.[8]

Independent Directors are independent fiduciaries who have a "special obligation under federal law to watch out for the interests of the shareholders against potential management overreaching or abuse."[9] They do not and should not engage in the micromanagement of the day-to-day operations of Registered Funds, including determining when and how to buy specific derivatives and how, exactly, to use those derivatives to achieve their funds' investment objectives. Indeed, under the 1940 Act, this is precisely the role of the investment adviser hired and overseen by the Directors. As outlined below, we question whether the role Directors play

---

[5] The 1940 Act contains a number of provisions that apply to the use of derivatives by Registered Funds, including with respect to the economic leverage that many derivatives entail (See Section 18(f) of the 1940 Act, and SEC and SEC Staff interpretations thereof). Form N-1A under the 1933 Act governs the content of the public offering materials of Registered Funds. On July 30, 2010, the SEC staff provided supplemental guidance to Registered Funds regarding their public disclosures about derivatives use. http://www.sec.gov/divisions/investment/guidance/ici073010.pdf .

[6] *See, e.g. Risk Principles for Fund Directors,* Report of the Mutual Fund Directors Forum, available at http://www.mfdf.org/director_resources/resource/risk_principles_for_fund_directors_april_2010/.

[8] Letter from Arthur Levitt, Chairman, Securities and Exchange Commission, to Matthew P. Fink, President, Investment Company Institute, dated June 17, 1994.

[9] Fund Governance: Legal Duties of Investment Company Directors, Robert A. Robertson at p. 2-52 (2007).

with respect to the Registered Funds they oversee is the type of role that the Commission should seek to regulate.

II. The Forum's Comments on the CPO Proposal

1. General Comments

Most fundamentally, a dual system of regulation is unnecessary and, potentially incompatible with Funds' current regulatory scheme.

As a membership organization for Independent Directors, much of our comment focuses on the potential impact of the Commission's rule proposal on Directors. However, we also agree with many others in the fund industry that it is not obvious that these rule changes are necessary. The CPO Proposal would cause a significant number of Registered Funds to be subject to CFTC regulation. Doing so will impose significant additional costs on Registered Funds – costs that likely will be passed on to their shareholders – without clearly providing fund investors with protections over and above those of the 1940 Act. We, therefore, question whether the Commission has adequately justified imposing these new requirements and encourage the Commission to reconsider carefully the need for these rules.

In addition, if adopted, the rule proposal would subject those Registered Funds that register with the CFTC to dual regulatory regimes under the authority of the SEC and CFTC which will entail numerous inconsistencies and uncertainties. Subjecting Registered Funds to inconsistent requirements is not in the interest of the Funds and their shareholders and may ultimately serve only to eliminate the range of investment strategies available to those who invest in Registered Funds. Should the Commission go forward with any form of this proposal, we believe that it must eliminate as many of these inconsistencies as possible.

2. Fund Directors and the CPO Proposal

The CPO Proposal creates undesirable uncertainty for Registered Funds and their shareholders because of the possibility that Directors, including Independent Directors, could be deemed to be any one or more of the following: a CPO in the person's own right, or an "associated person" or a "principal" of a Registered Fund that is subject to CFTC regulation.

Fund Directors as CPOs

The Commission Should Not Adopt any Proposal that Results in Directors Being Designated as CPOs.

Under current regulations, a CPO encompasses "any person engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, who, in connection therewith, solicits, accepts, or receives from others, funds..." The CFTC previously has interpreted the definition of CPO to include any person who exercises a certain degree of authority over the commodity pool (e.g., the authority to retain or change the

commodity trading adviser or futures commission merchant).[10] Because Directors may be assumed to be "engaged" in some of these activities by virtue of the obligations imposed upon them by state law and the 1940 Act, the Commission's proposal may result in Directors being designated as CPOs.

Specifically, the Commission has previously treated directors of a commodity pool as CPOs in their own right, rather than as principals or associated persons of the CPO. In CFTC Staff Letter 10-06 ("06 Letter"), the CFTC noted its longstanding position that "where a commodity pool is organized as a trust, each trustee of the pool is a CPO and, absent relief, would be required to register as a CPO under Section 4m(l)" of the Commodities Enforcement Act.[11] In the 06 Letter, such relief was contingent on representations that the "Trustees will have no authority or responsibility to direct or manage the affairs of the Fund." This relief would be unavailable for the Independent Directors of Registered Funds because the Directors by law must oversee the investment and other activities of the Funds and can terminate, among other things, the Funds' contracts with their investment advisers.

We do not perceive any benefit to designating Directors as CPOs. As we have outlined above, both the Congress and the SEC have assigned Directors extensive oversight responsibilities with respect to their Funds. While those oversight functions are crucial to the protection of investors in Registered Funds, the oversight responsibilities are fiduciary in nature. Directors do hire advisers and others to manage the day-to-day operations of the Registered Funds, but they themselves neither do so nor otherwise micromanage their funds.

The requirements and obligations Directors would incur as a result of being designated as a CPO, such as a Series 3 exam,[12] would be superfluous and irrelevant and would impose unnecessary costs on Registered Funds. The Series 3 exam is a two and one-half hour exam, required of all individuals who sell commodities or future contracts. It covers such topics as the definitions of future contracts, hedging and speculating, the operation of various investment strategies, technical analysis and spread trading, calculation of gain and loss, and other matters such as floor procedures and reporting rules. While Directors do need a basic understanding of both the commodities markets and the specific instruments that are traded in those markets to

---

[10] *See* 50 Fed. Reg. 15868, at 15871 and note 26 (Apr. 23, 1985). Note 26 states that the Commission noted in its proposal: "Frequently, Commission staff is called upon by members of the public to offer guidance on determining who, in fact, would be the CPO of a particular pool. In providing such guidance, the staff typically looks at such factors as who will be acting in the manner contemplated by the statutory definition of the term commodity pool operator- e.g., who will be promoting the pool by soliciting, accepting or receiving from others, property for the purpose of commodity interest trading-and who will have the authority to hire (and to fire) the pool's CTA and to select (and to change) the pool's FCM."

[11] CFTC Staff Letter 10-06 [Re: Section 4m(l); Regulations 4.21, 4.22 and 4.23], Commod. Fut. Law Rptr. ¶31,557, Commodity Futures Trading Commission, (Mar. 29, 2010).

[12] Under the Commission's regulations, each CPO must have one Associated Person that has passed the Series 3 exam.

oversee effectively their funds, the specific knowledge required to pass the Series 3 exam goes far beyond this and is not correlated with the knowledge required on the part of Directors.

Apart from the time and cost necessary to pass the Series 3 examination, this requirement (and others related to designation as a CPO) may well lead current Directors to resign from the boards of their Funds and may limit the pool of individuals willing to serve as Directors. While this might be acceptable if there was a clear need for Directors to be treated as CPOs, the Commission has not identified any benefits that would flow from this designation and, in particular, has not demonstrated how these requirements would increase the protection already afforded Fund investors under the 1940 Act.

We therefore encourage the Commission to provide broad exemptive relief to Independent Directors should it choose to adopt this proposal. We disagree with the petition of the National Futures Association ("NFA"),[13] which advocates use of a limited relief from CPO registration requirements that was earlier proposed by the Commission.[14] That rule proposal, which would allow Independent Directors of commodity ETFs to avoid registration as CPOs, is incompatible with the regulatory scheme governing Independent Directors of Registered Funds. As a condition of that proposed relief, Directors would be able to do nothing more than act as audit committee members. Because the 1940 Act requires that Directors perform other significant duties, Directors of Registered Funds could not reasonably be expected to meet that requirement. The suggestion of the NFA that this serve as a model for dual regulation of Registered Funds by the SEC and the CFTC is therefore unworkable.

Fund Directors as Principals or Associated Persons

The Commission Should Not Adopt any Proposal that Results in Directors Being Designated Associated Persons or Principals of a Fund Subject to CFTC Regulation

Even if adoption of the current proposal would not result in Directors being designated as CPOs, it creates a further risk that a Director would be treated either as an "associated person" ("AP")[15] of a CPO or as a principal[16] of a Fund subject to CFTC regulation.

---

[13] NFA Letter, dated August 18, 2010, to CFTC re Petition for Rulemaking to Amend CFTC Regulation 4.5 at http://www.cftc.gov/stellent/groups/public/@requestsandactions/documents/ifdocs/nfapetitionamend4-5.pdf.

[14] Commodity Pool Operators: Relief From Compliance with Certain Disclosure, Reporting and Recordkeeping Requirements for Registered CPOs of Commodity Pools Listed for Trading on a National Securities Exchange; CPO Registration Exemption for Certain Independent Directors or Trustees of These Commodity Pools, 75 FR 54794 (Sep. 9, 2010).

[15] 17 CFR §1.3(aa). APs of a CPO meet the definition of CPO yet are required to register as APs, not as CPOs in their own right. The CFTC believes that the registration requirement for associated persons "includes all those individuals in the line of supervisory authority over the associated persons who solicit and accept customers orders." "Interpretative Statement Regarding the Scope of the Term 'Supervision' in the Associated Person Registration

Designating Directors as APs or as principals would not create any obvious benefits while at the same time increasing the costs imposed on Registered Funds that are borne by their shareholders. For example, as with CPOs, APs are called upon to take the Series 3 examination. As we have suggested above, the knowledge required to pass this test is not clearly related to the role Directors play with respect to Registered Funds. Moreover, requiring the test may create disincentives for otherwise highly qualified individuals to serve as Directors of Registered Funds. We, therefore, urge the Commission to clarify as part of any rule adoption that Independent Directors are not APs.

Likewise, designation of Independent Directors as principals of a Registered Fund subject to CFTC regulation would create uncertainty with respect to the Independent Directors' liability for the actions of the Registered Fund and any of its APs. Directors are already subject to established and well-understood liability under state law (and, in limited circumstances, under the 1940 Act) for violation of their duties as fiduciaries of the fund. These liability schemes are consonant with the role that Directors play in overseeing rather than managing the day-to-day affairs of Registered Funds. In contrast, the Commission's proposal creates a risk that Directors will be subject to additional liabilities. For example, it is unclear whether Independent Directors as principals of a Fund subject to CFTC regulation would be subject to controlling person or aiding and abetting liability with respect to violations of the Commodity Exchange Act or its rules thereunder by the Registered Fund subject to CFTC registration or its investment adviser. The proposal fails to identify any clear and consistent reason why Independent Directors should be so liable. We, therefore, urge the Commission to clarify as part of the adoption of any rule that Independent Directors are not principals of CPOs.

III. Conclusion

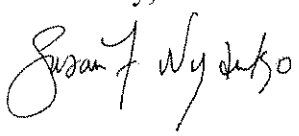
The CPO Proposal, which would affect a significant number of Registered Funds, does not entail rational or sensible recognition of the important and unique role of their Independent Directors. The Commission needs to make material changes in the way it would address the role of the Directors of Registered Funds, and particularly the Independent Directors. As we have outlined above, at a practical level, the special role of Independent Directors as independent fiduciaries who are charged with significant oversight responsibilities must be a key consideration. Rulemaking and guidance that recognizes this will, in the end, permit Independent Directors to continue to serve effectively the best interests of Fund shareholders.

Requirement," [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) 121,069 (CFTC, Aug 14, 1980)

[16] The NFA explains that "Individuals who, through their conduct or activity, directly or indirectly control a registrant are principals of the registrant, irrespective of their formal title or financial interest in the registrant." NFA website: http://www.nfa.futures.org/nfa-registration/principal/index.HTML

We would welcome the opportunity to discuss these comments further with you. If you have any questions or would like to further discuss these comments, please contact me at 202-507-4490.

Sincerely,



Susan Ferris Wyderko
Executive Director

cc: The Honorable Gary Gensler
The Honorable Michael Dunn
The Honorable Jill E. Sommers
The Honorable Bart Chilton
The Honorable Scott D. O'Malia

The Honorable Mary L. Schapiro, SEC Chairman
The Honorable Kathleen L. Casey, SEC Commissioner
The Honorable Elisse B. Walter, SEC Commissioner
The Honorable Louis A. Aguilar, SEC Commissioner
The Honorable Troy A. Paredes, SEC Commissioner

Eileen Rominger, Director, SEC Division of Investment Management