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April 12, 2011

Via E-Mail and Overnight Mail

Mr. David A. Stawick
Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Re: Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (RIN No. 3038-AD30).

Dear Mr. Stawick:

AQR Capital Management, LLC ("AQR")[1] appreciates the opportunity to provide comments to the U.S. Commodity Futures Trading Commission (the "Commission" or "CFTC") on its notice of proposed rulemaking on amendments to compliance obligations for commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"), each as defined under the U.S. Commodity Exchange Act ("CEA").[2] Please note that in this letter we are commenting specifically on the proposed amendments contained in the Release which will serve to reinstate operating criteria for exclusion from the CPO definition in Section 4.5. The Commission proposes to amend Section 4.5 with respect to registered investment companies ("RICs") ("Proposed Rule 4.5"), as proposed by the National Futures Association's ("NFA") petition for rulemaking, which proposed the reinstatement of the pre-2003 operating restrictions in Section 4.5 (the "NFA Petition") in

[1] AQR, a Delaware limited liability company formed in 1998, is an investment management firm employing a disciplined multi-asset, global research process (AQR stands for Applied Quantitative Research). AQR's investment products are primarily provided through a limited set of collective investment vehicles, separate accounts and mutual funds that deploy all or a subset of AQR's investment strategies. The AQR Funds were created to provide mutual fund investors access to these alternative, innovative and diversifying strategies. AQR acts as investment adviser to the AQR Funds, a Delaware statutory trust registered as an open-end management investment company under the Investment Company. AQR is registered with the U.S. Securities and Exchange Commission ("SEC") as an investment adviser under the Investment Advisers Act of 1940, as amended. With respect to certain of its products, AQR is also registered with the Commission as a CPO as well as a commodity trading advisor and is a member of the NFA. As adviser to the AQR Managed Futures Strategy Fund, a fund mentioned in the original NFA Petition, AQR has a particular interest in providing comments on the proposed amendment.

[2] *Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations,* 76 FR 7976 (February 11, 2001) ("Release").

an effort to "more effectively oversee its market participants and manage the risks that such participants post to the markets".[3]

AQR shares the NFA and CFTC's goal that all fund managers, whether registered with the CFTC as CPOs or with the SEC as investment advisers, should meet high standards of customer protection and transparency. We are not questioning the Commission's authority to "reconsider the level of regulation that it believes is appropriate with respect to entities participating in the commodity futures and derivatives markets,"[4] however, the task of harmonizing CFTC and SEC regulatory requirements will be a complex and difficult one. Having said that, we do believe that a workable, dual regulatory regime may be achieved if the operating relief outlined herein is provided. Commodity-focused funds and other funds that utilize futures can be an important part of an individual's diversified investment portfolio. As part of the mutual fund industry's attempt to offer investors the ability to include commodities as part of their overall investment portfolio, AQR's goal is to deliver such products while also ensuring the public receives the benefits of investor protection, low fees and transparency associated with investing through registered investment companies. We are deeply committed to working with both the CFTC and NFA to ensure that the benefits of such funds are preserved for investors.

The Commission recognizes that Proposed Rule 4.5, as contained in the Release, may cause some commodity pools to become registered with more than one regulator and requests comments with respect to the regulation of such entities.[5] AQR, as stated in our comment letter filed on October 18, 2010 in response to the NFA Petition (the "Original Comment Letter"), continues to have concerns that Proposed Rule 4.5 may have the effect of certain unintended consequences by virtue of requiring RICs invested in commodity futures and other derivatives to comply with both the Securities and Exchange Commission's ("SEC") regulations under the Investment Company Act of 1940 ("Investment Company Act") as well as the Part 4 Regulations promulgated under the CEA. As detailed in our Original Comment Letter, there are some similarities between the two regimes; however, there are certain key requirements across the two regulatory regimes that are either wholly inconsistent or entirely in conflict with each other, particularly in the areas of (1) presentation of past performance; (2) fee disclosure; and (3) Disclosure Document delivery, amendments thereto and deemed acknowledgment of such documents, all as discussed more fully below. We are neither opposed to harmonization nor dual regulation so long as the Commission understands that, without granting RICs and associated entities appropriate regulatory relief, the current Proposed Rule 4.5 is tantamount to shutting down such managed-futures funds as it would be impossible to effectively offer such products. AQR, in addition to other

[3] 76 FR 7976, 7984; *see also* 75 FR 56997 (September 7, 2010). NFA's Petition requests that any entity filing for an exclusion from Section 4.5 with respect to a RIC include in its notice of eligibility a representation that the RIC's qualifying entity: (1) will use commodity futures or commodity options contracts solely for *bona fide* hedge purposes; (2) will not have initial margin and premiums required to establish any commodity futures or commodity options not used for bona fide hedging purposes exceeding five percent of the liquidation value of the qualifying entity's portfolio; and (3) will not be marketed to the public as a commodity pool or as a vehicle for investment in commodity futures or commodity options.

[4] *Id.*

[5] 76 FR 7976, 7984.

industry participants and practitioners served on the NFA's Special Committee to Review Changes to Regulation 4.5 (the "Committee") and we generally endorse their proposal and comments.

Executive Summary

To the extent the Commission determines to proceed with Proposed Rule 4.5, we respectfully urge the Commission to grant relief to a CPO offering a managed-futures mutual fund from the Part 4 performance disclosure and disclosure document delivery requirements, provide a workable definition of "marketing" to determine whether a fund is holding itself out or marketing itself as a commodity fund, and allow a reasonable implementation period (at least one year after adoption of any new rule).[6] Please note our primary goal is to provide investors as much protection as possible in the context of a "smart" regulatory regime, while ensuring that there is a "level playing field" amongst managed-futures funds such that any associated burdens and costs of complying with two different regulatory regimes is not avoided by similarly situated funds due to differing or aggressive interpretations of applicable law.

Our comments set forth below will primarily attempt to (i) address our concerns with respect to unintended consequences highlighted in our Original Comment Letter; (ii) identify potential pitfalls in the five percent trading limitation (as proposed in the Release); (iii) explain our proposals to address the "marketing" prong of the Proposed Rule; and (iv) reinforce the ability of RICs to continue to be permitted to use a wholly-owned subsidiary structure. We will then attempt to highlight our concerns surrounding harmonization of the two regulatory regimes while proposing some sensible solutions, including the CFTC's grant of appropriate, operational relief from certain of the Part 4 Regulations.

Avoidance of Unintended Consequences

We believe the regulatory changes suggested by the Commission, as set out in the Release, can lead to negative unintended consequences as highlighted in our Original Comment Letter. However, we believe that such unintended consequences, mainly due to overbroad interpretations resulting in any Proposed Rule 4.5 changes affecting funds for which the rule was not likely intended, can be avoided given appropriate attention, resources and thought at both the industry and Commission level. Commodity-focused RICs have been a fixture in the asset management space for several years and have, to our knowledge, operated without issue under a comprehensive Investment Company Act regulatory regime. While we believe that the Investment Company Act's regulation of such funds (as well as regulation of the fund's adviser under the Investment Advisers Act of 1940) has been sufficient, we understand that the Commission's expertise in this area, familiarity with the CEA and with certain derivative instruments used in managed-futures style products would be beneficial from an investor protection perspective.

[6] *See e.g.*, Section 416 of the Dodd-Frank Wall Street Reform and Consumer Protection Act which provides unregistered investment advisers a one-year transition period for registration under the Investment Advisers Act of 1940, as amended.

As currently drafted, many funds in scope of the Proposed Rule would not be able to satisfy both the rules of the Investment Company Act and the CEA due to the conflicting nature of their rules and regulations. If it is determined that additional regulation by the CFTC is necessary, we respectfully urge the CFTC to defer issuance of any final rule until harmonization of the two regimes is established, and to provide operating relief from certain provisions of Part 4 of the CFTC Regulations.[7]

The Five Percent Trading Limitation

The proposed amendments to Regulation 4.5 would impose certain operating restrictions on those RICs seeking an exclusion from CPO registration. In particular, in order to qualify for the exclusion, a qualifying person must represent that the RIC does not exceed the 5% non-hedge restriction on the margin and premiums required to establish commodity futures, commodity options and swap positions (the "5% Trading Limitation"). This requirement presents some concerns, namely the ability for funds to "game" this limitation by moving into less liquid, more risky instruments such as "uncleared" swaps in order to avoid higher margin requirements. This clearly runs counter to the Commission's investor protection goal. It is important that the Commission note that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") may also cause higher margin requirements, but the degree to which margin requirements will rise and across which products remains to be seen given the status of rulemaking initiatives. In addition, many advisers are able to negotiate lower margin rates in exchange for higher financing costs which would only serve to pass on higher costs to investors.

In discussing the 5% Trading Limitation, the Committee was concerned that there were funds that may at times exceed the 5% non-hedge limit but were really not the types of funds that should be subject to any harmonized Part 4 requirements, particularly those related to the content and use of Disclosure Documents. In order to avoid that outcome, the Committee discussed the concept of a bifurcated structure that would impose one level of requirements on RICs that exceed the 5% non-hedge limit and additional

[7] With respect to certain of the regulatory inconsistencies, especially those relating to (i) the need for a single harmonized "disclosure document" or two separate documents (e.g., the Registration Statement as required under the 1940 Act and the Disclosure Document mandated by the CEA); (ii) conflicts relating to the substantive content of the two "disclosure documents"; (iii) fee disclosure; (iv) presentation of past performance; and (v) amendments to "disclosure documents", we respectfully request that the Commission consider providing relief as appropriate and raise such issues before the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues. *See* CFTC and SEC Announce Creation of Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues, CFTC, May 11, 2010 http://www.cftc.gov/PressRoom/PressReleases/pr5820-10.html. On May 11, 2010, CFTC Chairman Gary Gensler and Securities and Exchange Commission Chairman Mary Schapiro announced the formation of a joint committee that will address emerging regulatory issues. The establishment of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues was one of the 20 recommendations included in the agencies' harmonization report issued in 2009. The joint committee is intended to develop recommendations on emerging and ongoing issues relating to both agencies. The Committee's charter provides for a broad scope of interest, including: (1) identifying of emerging regulatory risks; (2) assessing and quantifying the impact of such risks and their implications for investors and market participants; and (3) furthering the CFTC's and SEC's efforts on regulatory harmonization.

requirements on those RICs that also engaged in marketing the fund (or should be marketing the fund) as a vehicle for trading directly or indirectly in the commodity futures, commodity options or swap markets. We believe this is a sensible approach in order to avoid any unintended broad reach of Proposed Rule 4.5 which we feel may otherwise result if Proposed Rule 4.5 were to be adopted as currently in its current form.

- Trigger of 5% Trading Limitation—CPO Registration Only

  AQR feels that any RIC that engages directly or indirectly in a certain level of non-hedge commodity futures, commodity options, and swaps trading should be subject to the CFTC's regulatory jurisdiction. Therefore, under this structure, we feel that any RIC that exceeds the 5% non-hedge requirement should be required to register with the CFTC as a CPO and be subject to certain reporting requirements, particularly those related to the CFTC's proposed enhanced pool reporting requirements. RICs that do not trigger the 5% non-hedge trading limitation would not be required to register or comply with the harmonized Part 4 Requirements unless the RIC triggered the marketing restriction, which AQR believes would be unlikely.[8]

- Marketing Limitation—Harmonized Part 4 Regulations

  In addition to the 5% Trading Limitation, Proposed Rule 4.5 would require that a RIC seeking to rely on the Rule 4.5 exclusion represent that it will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as in or a vehicle for trading in *(or otherwise seeking investment exposure to)* the commodity futures, commodity options, and swaps markets. The Committee felt that RICs that either hold themselves out or market themselves in this manner should be required to both register and comply with the harmonized Part 4 requirements. We feel strongly that a RIC should not trigger the marketing limitation simply because the RIC merely mentions in its promotional material/prospectus that it may invest in commodity futures, commodity options or swaps.

  Based on the above bifurcated structure, certain RICs (e.g., those above the 5% Trading Limitation) may attempt to tailor their marketing material/prospectus so as not to trigger the marketing restriction and subsequent necessity to comply with the harmonized Part 4 requirements. In response to this issue, the Committee

[8] AQR respectfully requests that the Commission exclude futures and swaps used for "equitization" purposes or for purposes of achieving stock-only exposure in computing the 5% Trading Limitation. While we do not see a need to expand the definition of bona fide hedging under Rule 1.3(z) of the CEA, the Commission may want to consider carving out those positions economically appropriate to the reduction of risks in the conduct and management. Recently, the CFTC has applied the concept of risk management in proposing an exception from mandatory clearing requirement for swaps subject to certain "risk-reducing" conditions. *See End-User Exception to Mandatory Clearing of Swaps*, 75 Fed. Reg. 246 (Dec. 23, 2010) (CFTC proposal for elective exception from mandatory clearing requirement for swaps subject to conditions including, among others, that the entity be using the swap to hedge or mitigate against commercial risk).

considered adding another prong to the marketing restriction or an additional separate operating restriction so that RICs whose primary investment strategy or return objective involve investing in the commodity futures, commodity options, and swaps markets would not qualify for the exclusion from CPO registration under Regulation 4.5. We also examined whether an objective test exists to determine whether a particular RIC's primary investment strategy or return objective should trigger compliance with the harmonized Part 4 Requirements.

At the suggestion of the Committee, AQR reviewed a number of No-Action letters issued by the SEC's Division of Investment Management regarding the issue of whether certain commodity pools were required to register with the SEC as investment companies (collectively, the Peavey letters).[9] The SEC developed a test for determining the primary business of a fund and stated that in determining the primary business of a fund, the most important factor is the portion of the fund's business from which it anticipates realization of the greatest gains and exposure to the greatest risk of loss. The SEC went on to say that a commodity pool's primary business should be deemed to be investing or trading commodity interests if, among other things, (1) the pool looks primarily to commodity interests as its principal intended source of gains; and (2) the pool anticipates that commodity interests present the primary risk of loss.

Under the Peavey analysis, in determining whether an entity investing in futures was otherwise primarily engaged in the business of investing in securities so as to be an investment company, the SEC considered the composition of the entity's assets, the sources of its income, the area of business in which it anticipated realization of the greatest gains and exposure to the largest risks of loss, the activities of its officers and employees, its representations, its intentions as revealed by its operations, and its historical development. The SEC recognized that with respect to a commodity pool, "a snapshot picture of its balance sheet contrasting the value of its futures contracts (unrealized gain on such contracts) with the value of its other assets" may not reveal the primary nature of the business as a pool's reserves and margin deposits are generally in the form of United States government notes and other securities. In Peavey, the SEC stated that of greatest importance in its analysis was the area of business in which the entity anticipated realization of the greatest gains and exposure to the largest risks of loss as revealed by its operations on an annual or other suitable basis.

The SEC's staff stated in Peavey that, for the purpose of determining whether a pool is an investment company under either Section 3(a)(1)(A) or Section 3(a)(1)(c) of the Investment Company Act, it must determine whether it is "primarily engaged in the business of investing in futures and options on futures rather than being primarily engaged in investing and trading in securities." In

[9] *See* Peavey Commodity Futures Fund, SEC No-Action Letter (pub. Avail. June 2, 1983), 1983 SEC No-Act. LEXIS 2576 ("Peavey") (determining the primary engagement of a fund for purposes of the Investment Company Act). *See also*, Tonopah Mining Co. of Nevada, 26 S.E.C. 426 (1947) (adopting a five-factor analysis for determining an issuer's primary business of assessing the issuer's status under the Investment Company Act).

determining whether a commodity pool is primarily engaged in the business of investing in futures and options on futures, the Staff would principally look to "whether the pool anticipates realizing its greatest gains and being exposed to its largest risk of loss from such investments and whether the pool in fact realizes its greatest gains and being exposed to its largest risk of loss from such investments." Due to the fact that, under the IRS Private Letter Rulings, under which our Managed Futures Fund operates, we can only invest 25% of NAV in commodity-related investments, coupled with the fact that this test is very malleable and can change from year-to-year, we do not feel that Peavey should be the sole driver of the marketing test. In addition, a fund that uses futures solely to obtain long-only exposure on a net basis could be caught up in this test. We do not believe that the Commission is trying to capture a long-only, financial-futures type of fund or a fund that uses futures or swaps to provide exposure to securities or security indices. This would also be a large burden for the Commission's Staff given their limited resources.

As such, we believe this test would be useful in determining whether a RIC should comply with the harmonized Part 4 requirements but should not be the sole test, whereby a RIC would be subject to the harmonized Part 4 requirements if it looked primarily to futures/options/swaps as its intended source of gains and anticipated that these interests would present the primary risk of loss. This type of test may need further refinement, such as setting a time frame, so, for example, a RIC may be subject to harmonized Part 4 requirements if it received more than a certain percent (i.e., 50%) of its profits/losses from futures trading, swaps or notes with respect to commodities (rather than securities) in the previous three years.

AQR also reviewed, in connection with Committee members, whether using the aggregate net notional value of the futures/options/swaps positions held by the fund could serve as an appropriate triggering criteria. In particular, if a RIC or any of its subsidiaries directly or indirectly held futures/options/swaps positions with an aggregate net notional value that exceeds a certain percentage (i.e., 100%) of the fund's net liquidating value (after taking into consideration unrealized gains and unrealized losses on those positions), then the RIC would be required to comply with the harmonized Part 4 requirements. We have given this some thought and generally feel that a trading-level test would result in unintended consequences by covering funds that should not be subject to CPO registration and harmonized disclosure. For example, a bond fund uses interest rate futures to express a view on an asset class and may inadvertently trigger a net notional test. For example, one Eurodollar futures contract could cause a fund to violate this "net notional" test. Even so, at 20% futures usage, a fund can materially vary the volatility level of a fund that such a fund is more "risky" than a passive S&P 500 fund.

As such, AQR believes that neither of these tests standing alone would necessarily capture those funds (e.g. whose primary investment strategy or return objective) that should trigger compliance with the harmonized Part 4

requirements. Rather than continuing to try to develop the appropriate objective test, we believe the best way to identify those funds that should trigger compliance with the harmonized Part 4 requirements is for the "no-marketing" restriction to contain language targeting those funds that not only market, but rather "should be" marketing participations to the public as or in a commodity pool or otherwise or in a vehicle for trading in *(or otherwise seeking investment exposure to)* the commodity futures, commodity options, and swaps markets. We, along with members of the Committee, have identified a set of factors that may be used as indicia to determine whether a fund meets the "should be" marketing criteria.

The factors identified include:

- A fund's name
- Is the fund's primary investment objective tied to a commodity index?[10]
- Peavey test
- A net notional value test
- Do the fund's marketing materials refer to the benefits of the use of commodities in a portfolio or make comparisons to a commodity index?[11]
- Does the fund use more than a certain percentage of its assets to margin futures positions or purchase swaps or notes – this percentage would range from a 5% floor to a higher percentage (i.e., 10%)?[12]
- During the course of its normal trading activities does the fund or an entity on its behalf have a net short speculative exposure to any commodity through a direct or indirect investment in or other derivatives?[13]

[10] While the first two indicia (including a fund's name) are easy to work around, they are clear and unambiguous and should serve to help identify funds. No one will unintentionally call their fund a "managed futures" strategy fund and accidentally be included in the marketing prong of Proposed Rule 4.5. We urge the Commission to consider adding "key words" in the Adopting Release of the final rule (e.g., "futures") to provide some more guidance on this point.

[11] Many funds which have some commodities exposure will have marketing materials arguing for the benefits of diversification in general which may very well include commodities. This criteria, viewed in isolation, may capture so-called "target-date funds" and balanced funds.

[12] As mentioned above, the Commission should note that margin may be negotiated for swap exposures (in some cases down to zero for large firms). This indicator, viewed in isolation, could unintentionally capture funds that don't use many derivatives but, for some reason, have poor margin terms with their trading counterparties. In our experience some FCMs will charge 2x more exchange margin or higher if a fund has less than $20 million in assets. It could also have the unintended consequence of encouraging funds to move from the futures markets entirely into swaps in order to negotiate down margin terms which is why it is important that regulators, acting pursuant to the Dodd-Frank Act, set margin terms on an industry-wide basis for cleared swaps. Of course, that can lead funds to move toward more trading in non-cleared swaps and structured notes. Note, for example, have embedded 3x leverage with expensive embedded put options which is extremely costly for investors and may generate deleveraging risk (i.e., the issuer of the note will deliver the exposures automatically in the event of negative P&L of the exposure, causing a cascading of market prices). Basically, the tighter the "%" range is, the more of an incentive funds have to move away from easy-to-monitor and regulated futures positions into more exotic swap and note instruments which have significantly more embedded risk, both on an economic and counterparty basis.

[13] To clarify, we believe the test should carve out positions used for bona fide hedging of security-based positions (i.e., a manager buys a bond and shorts a future in order to manage duration exposure – so it

We believe this approach will capture the vast majority of funds that the Committee believes should be subject to the harmonized Part 4 requirements.

The question then becomes what is the best prophylactic remedy to ensure that funds are not "gaming" the marketing test.[14] In addition, what is crucial is how these indicia are used to assess marketing. These issues were discussed in the Committee and the general consensus was that it shouldn't be an all-or-nothing test (e.g., "if you satisfy 2 or 3 of the indicia then you are considered to be holding yourself out"). While we all would like the law to be clear and unambiguous this is very difficult to achieve. We urge the Commission, if they take up the above approach or any variation thereof, to include a good degree of clarifying language in the Rule's Adopting Release so that practitioners and industry participants can have a roadmap to accurately assess whether certain funds should be considered as "marketed to the public as a commodity pool or as a vehicle for investment in commodity futures or commodity options."

We do have some concerns around the "indicia" approach regarding the need to "self-police" the industry. Since, under the proposal contained herein, users exceeding the 5% Trading Limitation will still be subject to NFA/CFTC oversight and possible enforcement actions for trying to "game" the rules, we do have some comfort on that point as the above should be motivation enough for compliance. It should also be noted that the CFTC, via CPO registration of the fund's investment adviser, would have antifraud authority over such advisers and have the ability to perform fitness checks and, if necessary, to subject such advisers to examination. Another idea that we ask the Commission to consider is whether it is possible for funds to submit their offering materials to the NFA and/or CFTC to make a final determination as to whether the fund falls outside of the "marketing" bucket. If it is determined that the NFA and/or CFTC does not have the necessary resources to perform this exercise, we recommend that the

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shouldn't look only at the derivative positions in a fund's portfolio, but rather at the "total net economic position" for a given market as defined by country/asset class combination – i.e., US bond market, US Stock market, German stock market, etc.). Without this exemption we believe a large number of funds would unintentionally be included. Note that the Rule 1.3(z) definition of bona fide hedging currently focuses on whether a transaction or position is, among other things, "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise…." Examples of risk reduction other than managing duration could be transactions or positions taken by a fund in futures, options or swaps that are used (i) as an alternative or temporary substitute for "cash market" positions; (ii) to mitigate or offset changes in the value of "cash market" positions owned by the fund or non-derivative liabilities of the fund; (iii) to facilitate the fund's management of its cash and/or reserves; or (iv) to efficiently adjust a fund's exposure to one or more asset allocation categories. *See* the "1987 Interpretation" in which the CFTC excluded the use of financial futures and options for risk management from speculative limits (*Risk Management Exemptions From Speculative Position Limits Approved Under Commission Regulation 1.61,* 52 Fed. Reg. 34633 (September 14, 1987). Note also that, solely for purposes of this indication test, currency forwards and/or swaps should be excluded since, by definition, every such contract has a "long" and a "short" side so anyone with currency positions may unintentionally be included.

[14] We wish to highlight to the Commission's Staff that RICs could attempt to avoid the "should be" marketing criteria by utilizing commodity-linked notes in place of futures, options and swaps. We encourage the Commission to examine and address indirect exposure to the commodity futures markets, such as through commodity-linked, or structured, notes. While we acknowledge the Commission's jurisdiction over swaps under the Dodd-Frank Act, we note that 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.

onus be put on the registrant such that it would need to file a notice if such registrant didn't believe they were covered by the "marketing" prong of Proposed Rule 4.5.

In summary, we recommend a tiered registration system such that RICs that do not market themselves as commodity pools, according to the indicia suggested above, but do hold positions in commodity interests that exceed the 5% Trading Limitation would be subject to CPO registration but not otherwise be subject to CPO Regulation and the harmonized Part 4 Regulations. The rationale here is that such investment companies which may include, but are not limited to, fixed-income funds, index funds, balanced funds and "long-only" funds using financial futures to achieve equity exposure, do not raise the same investor protection concerns as other funds may and are not what the Commission is seeking to address in its Proposal. We are of the belief that it is neither necessary nor appropriate to subject advisers to these RICs to the harmonized Part 4 Requirements, particularly since these products are already subject to comprehensive regulation under the Federal securities law and rules under the Investment Company Act, coupled with the fact that such RICs are already subject to extensive public disclosure and reporting requirements to which the Commission would have access.

The 2nd, or "CPO-heavy" bucket would include those RICs who both market themselves as commodity pools, according to the indicia suggested above, *and* hold positions in commodity interests that exceed the 5% Trading Limitation would be subject to CPO registration *as well as* be subject to CPO Regulation and the harmonized Part 4 Requirements.

Obviously, those RICs that neither trigger the 5% Trading Limitation nor "market" themselves as commodity pools, according to the indicia suggested above, should not be subject to CPO registration nor should they have the harmonized Part 4 Requirements apply to them. In the off-chance that a RIC triggers the 5% Trading Limitation but does not "market" itself as a commodity pool, we would suggest they land in the "CPO-heavy" bucket and have their adviser register as CPOs with full compliance with the harmonized Part 4 Requirements.

RICs Should Continue to be Permitted to Use a Wholly-Owned Subsidiary Structure

The Release would require that any positions in swaps, commodity futures or commodity option contracts for non-hedging purposes would need to be held by a "qualifying entity only" (e.g., the RIC itself). This requirement would effectively preclude a RIC from using a wholly-owned and controlled subsidiary for futures, options and swaps trading.[15]

We understand that the NFA included this requirement in its Petition due to the original concern surrounding the perceived lack of transparency associated with a RICs

[15] The language is in the Release is apparently directed at investment companies' use of wholly-owned subsidiaries to engage in a limited amount of swaps, commodity futures, and commodity options trading (i.e., no more than 25% of an investment company's investment portfolio, as disclosed in its Registration Statement, and as specifically permitted by the Internal Revenue Service ("IRS")).

trading of commodity futures and related instruments performed via an entity that is neither an SEC-registered investment company nor a commodity pool regulated by the CFTC. AQR would like to emphasize, as it did in its Original Comment Letter, that use of this type of structure is for tax purposes and not to evade regulation under the Investment Company Act (RICs use wholly-owned subsidiaries in order to gain exposure to certain futures and commodities in a manner consistent with the limitations of the federal tax requirements in Subchapter M of the Internal Revenue Code of 1986, as amended (the "Code").[16]

We believe such requirements, along with industry practice, provide sufficient transparency and accountability regarding a RICs operation of a wholly-owned subsidiary. Furthermore, we strongly endorse the NFA's approach and request that the Commission permit RICs to use these subsidiary entities, provided that there is a requirement within Regulation 4.5 whereby the CPO agrees without condition to make the RIC's subsidiary's books and records available for full inspection by the CFTC and NFA. In addition, AQR would support a representation by the RIC that the subsidiary will comply with the key provisions of the Investment Company Act and disclose any fees charged by the subsidiary as well as individual positions held by the subsidiary.[17]

Harmonization of the Investment Company Act and CEA

We believe it is critical that the Commission work closely with the SEC prior to adopting any variation of Proposed Rule 4.5 in order to reconcile the overlapping and, in some cases, conflicting CFTC and SEC regulations to which managed-futures RICs would be subject. As outlined in our Original Comment Letter, RICs are subject to extensive disclosure and reporting requirements. While many of these are similar to the requirements to which CPOs are subject, there are certain requirements under the Investment Company Act and CEA that are wholly inconsistent and will require reconciliation between the two regimes. Nowhere are the inconsistencies more acute than in the areas of (1) presentation of past performance; (2) fee disclosure; and (3)

[16] Under Subchapter M of the Code, each registered investment company is required to realize at least ninety (90) percent of its annual gross income from investment-related sources (further defined in the Code), referred to as "qualifying income". Direct investments by RIUCs in commodity-related instruments generally do not, under IRS published rulings, produce qualifying income. As a result, many RICs applied for and received private letter rulings issued from the IRS allowing such funds to deal in commodity instruments while generating "qualifying income" so long as they comply with certain sections of the Investment Company Act.

[17] The IRS private letter rulings described above specifically require the subsidiaries to comply with Section 18 of the Investment Company Act and all associated guidance from the SEC regarding coverage and the use of leverage by registered investment companies. The majority of RICs that employ the subsidiary structure go further by operating the subsidiary in conformity with other key provisions of the Investment Company Act, notably Section 8 (investment policies) and Section 17 (affiliated transactions and custody requirements). In addition, most RICs (including the AQR Managed Futures Strategy Fund) are transparent with respect to fees and portfolio holdings (e.g., they fully disclose any fees charged by the subsidiary and include them in the overall expense ratio for the RIC, and disclose individual positions held by both the investment company and the subsidiary in the RICs quarterly regulatory filings as well as its annual and semi-annual reports to shareholders. Financial statements of the subsidiary are typically either included in the RICs annual and semi-annual reports to shareholders or consolidated with the financial statements of the RIC.

Disclosure Document delivery, amendments thereto and deemed acknowledgment of such documents. The following is a discussion of the major harmonization issues along with suggested solutions.

- Disclosure Document/Prospectus Delivery Requirements

Under the CEA, a CPO must deliver a Disclosure Document to a prospective participant no later than the delivery of a subscription agreement while, under the Investment Company Act, sales of a RICs securities must be accompanied or preceded by the fund's currently effective Prospectus. However, it is customary and acceptable for the Prospectus to be sent with the trade confirmation which can be sent as late as three (3) days after the trade date. The SEC also permits the use of a Summary Prospectus to solicit participants.

As a solution, we would urge the Commission to adopt relief similar to that proposed for commodity exchange-traded funds.[18] *CPOs would be exempt from the CFTC Part 4 requirements on delivery and "deemed receipt" so long as the CPO (i) made the Disclosure Document available on its website; (ii) notified prospective shareholders of the Disclosure Document's availability and the internet address; and (iii) instructed any selling agent or distributor to notify prospective participants of the same.*

- Disclosure Document Amendment Requirements

The CFTC currently requires that if any information delivered prior to the Disclosure Document is amended by the Disclosure Document in any material respect, the "participant" must receive the Disclosure Document at least forty-eight (48) hours before such participant's subscription is accepted. There is no similar requirement for RICs under the Investment Company Act.

As a solution we recommend that the Commission provide an exemption from this requirement for RICs that keep updated documents on its website, and otherwise comply with the proposed ETF relief.

Furthermore, the CFTC currently requires that a fund must update its Disclosure Document if it becomes materially inaccurate or incomplete, and must distribute an updated Disclosure Document to all *existing* participants within twenty-one (21) days of knowing the defect. Pursuant to the Investment Company Act, Prospectuses must be supplemented to reflect material changes in matters covered by the Prospectus. In

[18] *See* CFTC letter No. 08-01, January 11, 2008, Exemption, Division of Clearing and Intermediary Oversight, Regulations 4.21, 4.22 and 4.23 – Request for exemption from certain Disclosure Document, reporting and recordkeeping requirements in connection with the operation of the Fund. *See also* Federal Register Comment File: 10-013: 17 CFR Part 4 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.

addition, all supplements must be delivered to any shareholders that *make an additional investment.*

We recommend that the Commission provide an exemption from this requirement for RICs that keep updated Disclosure Documents on its website, and provide an indication that the document has been updated. As a result, any amendment delivered in a reasonable amount of time via website disclosure would constitute "delivery" for purposes of the CEA.

The CFTC also requires that any Disclosure Document be updated every nine (9) months in any case while the SEC requires an annual update every twelve (12) months.

We would recommend that the CFTC move to a 12-month updating timeline. Preserving a 9-month update for purposes of the "Disclosure Document" in addition to the 12-month requirement we currently adhere to for our fund's Registration Statements (or more frequent updates due to material changes), due to the frequency and timing of the updating process, would not only be excessively burdensome for the adviser, but would considerably drive up a fund's compliance, accounting and operational costs, with the majority of such costs being passed on to the fund's investors[19]*. This may put certain managed futures funds (already having gone to considerable expense to establish themselves as funds governed under the Investment Company Act) at a competitive disadvantage versus similar funds solely dealing with the CFTC regime. Specifically, if we go with one (1) harmonized document, the joint Prospectus/Disclosure Document would require updating every three-to-six months during a normal three-year cycle. In addition, if we preserve both the 9 and 12-month cycles, in many cases, funds would need to file Registration Statements without audited financial statements and then file again once the audited numbers are available.*

It is also worth noting that every RIC must file an annual report on Form N-CSR. Under Rule 30e-1, every RIC must send each shareholder of record, at least semi-annually within 60 days after the close of the period, a report containing: a balance sheet accompanied by a statement of the aggregate value of investments on the date of the balances sheet; a list showing the amounts and values of securities owned by the RIC; an itemized income statement; an itemized surplus statement; a statement of

[19] We believe that the Rule 4.5 Proposal could impose additional, significant costs on registered investment companies. These costs – some of which can be expected to be passed on to shareholders – would require, among others: (i) the costs of registering with the CFTC, and preparing for and taking required licensing examinations (which are different from licensing requirements that already apply to fund distributors and advisory personnel); (ii) the cost of preparing and distributing required disclosure documents and reports to investors (which would be different from the disclosures funds already provide to their investors); (iii) the cost of retaining counsel to attempt to reconcile and satisfy inconsistent regulatory requirements (if any following the harmonization process); (iv) the costs to upgrade systems to produce reports, coordinate and potentially develop new systems for vendors that currently assist in distributing investment company reports; (v) the costs of training salespeople; and (vi) the costs associated with the hiring and training of in-house counsel and compliance professionals, and costs associated with changes to fund compliance programs.

aggregate remuneration paid to officers and directors during the period covered by the report; and a statement regarding purchases and sales of securities. Note that the Form N-CSR must be filed within 10 days of transmitting such report to shareholders. The Form N-CSR is an annual report that contains, among other things, (1) a copy of the report transmitted to shareholders; (2) a schedule of investments; (3) any changes to the fund's Code of Ethics; and (4) principal accountant fees and services. It is also important to note that, similar to the CFTC annual report requirement, the Form N-CSR, pursuant to the requirements of Sarbanes-Oxley, requires an oath that the information contained in the document is accurate and complete to the best of the signatories' knowledge. In addition, Rule 30b1-5 of the 1940 Act requires every RIC to file a quarterly report on Form N-Q within 60 days after the close of the first and third quarters (Form N-Q includes provision of a schedule of investments among other things, and also requires an oath that the information contained in the document is accurate and complete). Finally, under Rules 30e-1 and 30b2-1, a RIC must send to its shareholders a semi-annual report on Form N-CSRS (covers similar information as that which is required to be in the annual report on Form N-CSR.

In terms of our rationale as to why a longer update cycle makes sense for managed futures-focused funds, we ask that the Commission consider the following:

- *Since Managed Futures-Focused Funds would be subject to two regulatory regimes (SEC and CFTC), there would be a lot more information provided to investors than if such a product were regulated solely by the CFTC.*
- *Performance information is readily available daily on the fund's website and accessible via other public sources (Yahoo, Bloomberg, etc.).*
- *Any material updates to the SEC's Prospectus/Registration Statement are required to be filed via a "sticker" pursuant to Rule 497 of the 1940 Act on a real-time basis, which is then promptly added to the fund's Prospectus for any new investors.*
- *If have both 9 and 12-month updating schedules, this will result in duplicative filings and since "audited financials" are likely not to be ready in time to update in the 9-month time frame, this will cause funds to file numerous times with the SEC (will have to file a supplement/post-effective amendment to add audited numbers).*
- *The new "XBRL" rules require compliance as of the beginning of this past year. Mutual funds are now required to file the new exhibit with the SEC, on the EDGAR system, in conjunction with initial registration statements and annual registration statement updates that become effective after January 1, 2011. XBRL mandates that a mutual fund's risk/return summary information include the fund's Investment Objective, Fee Table, Expense Example, Portfolio Turnover, Principal Investment Strategies, Principal Investment Risks and Performance information. The disclosure of this information is required by Items 2, 3 and 4 of Form N-*

1A.[20] The interactive data exhibit is filed with the SEC as a separate post-effective amendment to a mutual fund's registration statement pursuant to Rule 485(b) under the Securities Act of 1933, as amended ("Securities Act"). A mutual fund must file a post-effective amendment that includes the interactive data exhibit no later than 15 business days after the effectiveness of the related registration statement filing. The new rules do not change existing substantive disclosure or formatting requirements for mutual fund prospectuses. A mutual fund is required to post an interactive data exhibit on its website by the earlier of (1) the end of the calendar day that the interactive data exhibit was filed with the SEC, or (2) the date that the fund was required to file the interactive data exhibit with the SEC. Amendments to any XBRL data must be made "promptly". Regulation S-T, Rule 11 defines "promptly" to mean "[a]s soon as reasonably practicable under the facts and circumstances at the time." The definition is followed by a non-exclusive safe harbor, which provides that an amendment to an interactive data file that is made by the later of 24 hours or 9:30 a.m. on the next business day after a fund becomes aware of the need for a correction is deemed to be promptly made.

- Disclosure Document Acknowledgment Requirements

Currently, the CFTC Regulation 4.21 requires that a CPO not accept funds from a prospective participant unless it first receives an acknowledgment signed and dated by the participant stating that the participant received the Disclosure Document. If the Disclosure Document is delivery electronically, the CPO may receive the acknowledgment electronically through the use of a "unique identifier" to confirm the identity of the recipient of the Disclosure Document. There is no comparable acknowledgment under the Investment Company Act.

As mentioned earlier in this letter, we propose that the CFTC provide relief from the requirement that a signed acknowledgment be obtained prior to the investment being made. Similar to relief granted to commodity ETFs, we feel that a CPO maintaining an updated Disclosure Document on its website, along with a notification to prospective shareholders via a supplement to the Prospectus of the updated Disclosure Document's availability should suffice given operational complexities. This would allay any concerns as to an investor being able to make a fully informed decision in a daily, continuous offering.

- Fee Disclosure

The CFTC requires that the Disclosure Document must include a complete description of each fee, commission and other expenses which the CPO knows or should know has been incurred by the pool for its preceding fiscal year and is expected to be incurred by the pool in its current fiscal year. There is also a non-

[20] Form N-1A is a registration statement used by open-end investment companies to register their shares. *See* http://www.sec.gov/about/forms/formn-1a.pdf.

exhaustive list of fees that must be included in CFTC Regulation 4.24(i)(2), including management fees, brokerage fees and commissions, fees paid in connection with trading advice provided to the pool, incentive fees, commissions that may accrue in connection with the solicitation of participants in the pool and any other direct or indirect costs. In addition, the Disclosure Document must include a "break-even" point per unit of initial investment. The SEC mandates under its Form N-1A that RICs must include in their Registration Statement a fee table and expense example disclosing its fees and expenses. The fee table for RICs generally discloses:

- Shareholder fees (maximum sales charge imposed on purchases, maximum deferred sales charge, maximum sales charge imposed on reinvested dividends, redemption fees, exchange fees and maximum account fees);
- Annual operating fund expenses (management fees, distribution and/or service fees, other expenses) on a percentage basis; and
- Portfolio turnover rate as a percentage of the average value of its portfolio.

The fee table required by Form N-1A is <u>not</u> compatible with the CFTC's break-even table.

We believe that two possible alternative solutions exist to this issue. First, if the CFTC and SEC agree, these funds could be required to include both types of mandated fee disclosures—including the break-even analysis—in their Prospectus. In the alternative, CPOs offering these RICs could discuss with the SEC whether they can treat their underlying wholly-owned subsidiaries as "acquired funds", which we understand from an accounting perspective would result in the fee disclosures for these wholly-owned subsidiaries (and any investment vehicles held by these subsidiaries) being required to be disclosed under Part 4. CPOs would still also have to provide the mandated break-even analysis as supplemental information within the Prospectus. By using either of these formats, potential investors will be able to accurately compare fees between a pool registered under the Securities Act and a pool that is a commodity-related RIC, and between two pools that are commodity-related RICs. These are complex items and it is important to note that providing investors with duplicative and overlapping fee disclosure that does not match up may counter the Commission's goals in terms of investor protection.[21]

- <u>Advertising & Past Performance</u>

Another major conflicting area in terms of the two regulatory regimes concerns advertising and past performance. CFTC Regulation 4.25 requires that

[21] Note also the difficulty of separating out any managed futures fund Prospectus and Statement of Additional Information given the new summary prospectus, delivery and order of information requirements. *See* Release Nos. 33-8998; IC-28584; File No. S7-28-07, "Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies", also available at http://www.sec.gov/rules/final/2009/33-8998.pdf.

the CPO provide the offered pool's past performance information. If the pool has less than 3 years of operating history, the CPO must include performance information related to the other pools operated by the CPO, and in some instances the CTA, if applicable. The Staff of the SEC's Division of Investment Management has published guidance that indicates that it is inherently misleading to include performance of other RICs in the Prospectus unless the other RIC's investment objectives, policies and strategies are substantially similar to those of the offered RIC.

This issue will require compromise by both the CFTC and the SEC. A possible solution may be that the CFTC permits RICs to provide any performance information related to other pools or managed accounts required by CFTC Regulation 4.25 in the RICs Statement of Additional Information, which will be made available contemporaneously with the fund's Prospectus on the CPO's web site. As RICs provide daily liquidity and the vast majority of a RICs customers have access to their position's value daily via the internet, the Commission could adopt relief similar to Regulation 4.12(b)(2)(ii), which permits certain pools to distribute account statements no less frequently than quarterly. The priority here should be to arrive at a solution which doesn't provide misleading information to the investor or cause an adviser to violate Regulation D of the Securities Act should they need to disclose performance of private commingled funds for purposes of peer performance disclosure.

Conclusion

We support enhancing coordination, communication and consultation among the SEC, CFTC and NFA with respect to Proposed Rule 4.5. We believe the regulators should consider developing a shared internal database of advisers who engage in futures and securities activities to assist with regulation and oversight of registrants. We believe a shared database would facilitate and promote the sharing of information between the regulators and enhance coordination and regulation. Such a database would provide a regulator with information about an adviser that engages in securities and futures activities regardless of an adviser's registration status (*e.g.*, single or dual registrant). We also support a regulatory framework that requires an adviser to be subject to either the CFTC or SEC's registration framework depending on whether it is primarily engaged in the business of advising on futures or securities. To the extent that an adviser is equally or largely engaged in advising on both futures and securities, we believe the adviser should be registered with both the CFTC and SEC. We believe that such a framework, combined with enhanced SEC and CFTC coordination and communication, such as through a shared adviser database and with respect to examinations, would maximize regulatory efficiency and effectiveness while reducing compliance costs for advisers and their customers.

AQR appreciates the opportunity to share its views on Proposed Rule 4.5 and is committed to working with regulators to enhance our regulatory system. If the Commission has any questions or comments, please contact the undersigned at (203) 742-3618.

Sincerely,

/s/ Brendan R. Kalb

Brendan R. Kalb
General Counsel

cc: The Honorable Gary Gensler, Chairman
The Honarable Michael V. Dunn, Commissioner
The Honorable Jill E. Sommers, Commissioner
The Honorable Bart Chilton, Commissioner
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