Dechert LLP

1775 I Street, N.W.
Washington, DC 20006-2401
+1 202 261 3300 Main
+1 202 261 3333 Fax
www.dechert.com

April 12, 2011

David A. Stawick
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: CFTC Proposed Rulemaking to Amend Regulation 4.5 and Related Issues [RIN number 3033-AD30]

Dear Mr. Stawick:

Dechert LLP, on behalf of itself, OppenheimerFunds, Inc., Massachusetts Financial Services Company, Altegris Advisors, LLC, and a number of mutual funds and their investment advisers, welcomes the opportunity to comment on the proposed rulemaking of the Commodity Futures Trading Commission ("**CFTC**") regarding the modification of exclusionary relief and rescission of exemptive relief available to persons that would otherwise be required to register as commodity pool operators ("**CPOs**").[1] This comment letter addresses the proposed changes to CFTC Regulation 4.5 ("**Regulation 4.5**"),[2] which currently excludes from the definition of CPO investment companies registered under the Investment Company Act of 1940, as amended ("**1940**

[1] Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 76 Fed. Reg. 7976 (proposed Feb. 11, 2011) [hereinafter "**Proposing Release"**] (announced by the CFTC at an open meeting on January 26, 2011).

[2] 17 C.F.R. § 4.5. *See also* 7 U.S.C. § 1a(5).

Act"),[3] and addresses the proposed changes to CFTC Regulation 4.13(a)(4) ("**Regulation 4.13(a)(4)**")[4] as it applies to registered investment company wholly-owned offshore subsidiaries. This comment letter discusses certain but not all of the policy reasons why Regulation 4.5 and Regulation 4.13(a)(4) should not be changed, but primarily focuses on issues the CFTC's proposal would create for registered investment companies if required to comply with CFTC and Securities and Exchange Commission ("**SEC**") regulatory regimes.

As discussed below, we are of the view that current Regulation 4.5 and Regulation 4.13(a)(4), as they apply to registered investment companies, should remain unchanged. However, if the CFTC determines to adopt amendments to these rules, we caution the CFTC that its rulemaking actions are premature, as the impact and costs of the amendments cannot be assessed until further rulemaking is completed under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**").[5] In addition, we request that the CFTC address the fact that its proposal has the potential to force a considerable number of mutual funds[6] into dual registration with the

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[3] 15 U.S.C. § 80a-1 *et seq*.

[4] 17 C.F.R. § 4.13(a)(4).

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[6] For ease of reference, this letter uses the term "**mutual fund**" generally to refer to open-end management investment companies registered under the 1940 Act ("**registered investment companies**"). However, it should be noted that the proposed rules would apply equally to registered closed-end investment companies and exchange-traded funds that have registered as unit investment trusts.

SEC and the CFTC. Careful consideration should be taken to harmonize existing, duplicative and conflicting statutes and CFTC and SEC regulations or to provide appropriate exemptive relief to avoid unintended consequences to mutual fund shareholders and to ensure that retail investors continue to have access to mutual funds that invest in commodity futures, commodity options and swaps. The CFTC should not implement any amendments without further study of these issues and coordination with the SEC to minimize the disruptive impact that dual registration would have on mutual fund shareholders.

Introduction

Mutual funds are an important vehicle through which retail investors invest for current income, save for college tuition and retirement, and for a host of other investing needs. Mutual funds are an important way for retail investors to access markets while minimizing their investing costs. Some mutual funds offer asset allocation whereby a single shareholder's investment in one mutual fund is spread among different market sectors, asset classes or other funds in order to provide diversification and/or the ability to change the risk profile of the investment over time.[7] With regard to retirement saving, retirees cannot rely on social security payments to fund

[7] A subset of asset allocation mutual funds are "target date" or "life cycle" mutual funds. These funds offer asset allocation across other funds as well as portfolio rebalancing, becoming increasingly conservative as an investor reaches and/or passes a "target" retirement date. As of April 2010, assets under management in these mutual funds were $291 billion. Investment Company Institute ("**ICI**"), Target Retirement Date Funds Resource Center, *available at* http://www.ici.org/trdf (last visited April 8, 2011).

retirement adequately, and pensions are not as widely available as they once were.[8] It has become increasingly important for individuals to save for their own retirement and other needs, with many using mutual funds to do so. As of February 2011, the size of the mutual fund industry in the United States was over $12 trillion in assets under management.[9] As of early 2011, more than 87 million Americans, representing slightly less than half of all households, invest in over 9,000 mutual funds.

Most mutual funds have the authority to invest a portion of their assets in commodity futures, commodity options or swaps.[10] The 1940 Act expressly contemplates that registered investment companies may invest in commodities if adequate disclosure is made in their registration statements.[11] Many mutual funds invest in commodity futures, commodity options and swaps.[12]

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8 In 1975, 88% of private sector employees had pension coverage, but by 2005 only 33% of these individuals had access to a traditional pension plan. ALICIA MUNNELL, KELLY HAVERSTICK & MAURICIO SOTO, CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE, WHY HAVE DEFINED BENEFIT PLANS SURVIVED IN THE PUBLIC SECTOR? 2 (2007), *available at* http://crr.bc.edu/images/stories/Briefs/slp_2.pdf.

9 INVESTMENT COMPANY INSTITUTE, TRENDS IN MUTUAL FUND INVESTING, FEBRUARY 2011 (March 30, 2011), *available at* http://www.ici.org/research/stats/trends/trends_02_11.

10 Press Release, SEC Staff Evaluating the Use of Derivatives by Funds (Mar. 25, 2010) (quoting then-Director of the SEC's Division of Investment Management, Andrew Donohue, as saying, "[T]he use of derivatives by funds is not a new phenomenon."), *available at* http://www.sec.gov/news/ press/2010/2010-45.htm. SEC DIVISION OF INVESTMENT MANAGEMENT STUDY ON MUTUAL FUNDS AND DERIVATIVE INSTRUMENTS 3 (Sept. 26, 1994) ("Many non-money market funds have the authority to use derivative instruments."), *available at* http://www.sec.gov/news/studies/deriv.txt.

11 15 U.S.C. § 8(b)(1)(F); Form N-1A, Item 16(c)(1)(v).

They engage in these transactions for a variety of reasons, including hedging risk in cash market transactions, equitizing cash, managing portfolio risk, or gaining exposure to certain securities, indices, or asset classes.[13]

In addition, for a number of years there have been mutual funds with an investment objective to provide exposure to physical commodities as an asset class. Those funds, mostly through wholly-owned subsidiaries, use commodity futures, commodity options, and swaps on commodities or

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[12] Under the Commodity Exchange Act, as amended ("**CEA**"), the term "commodity" is defined to include all manner of physical items as well as intangible items, including "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in," such as foreign currency, broad-based securities indices, and interest rates. 7 U.S.C. § 1a(4). Under the Dodd-Frank Act, a "swap" is defined broadly to cover most commonly traded over-the-counter ("**OTC**") derivatives, including options on interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices and various other financial or economic interests or property, contracts in which payments and deliveries are dependent on the occurrence or non-occurrence of certain contingencies, swaps on rates and currencies, total return swaps, and various other common swap transactions. *See* Dodd-Frank Act § 721(a)(21). When the Dodd-Frank Act becomes effective, under the 1940 Act, the term "swap" will have the same meaning as under the CEA. Section 721(c) of the Dodd-Frank Act has directed the CFTC to provide further definition to the term "swap." Dodd-Frank Act § 721(c). The CFTC has requested public comments on the term "swap." Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Red. Reg. 51429 (Aug. 20, 2010) (advance notice of proposed rulemaking; request for comments). The term "swap" will include foreign exchange forward contracts, an OTC product widely used by mutual funds, unless the Secretary of the Treasury determines otherwise. Dodd-Frank Act § 721(a)(21). As a bespoke OTC product, swaps may be conducted on any underlying asset or reference item chosen by the parties to the swap.

[13] Although the use of futures, options and swaps can also allow an investor to leverage its assets, mutual funds are limited in this regard by the prohibition on the issuance of senior securities under Section 18(f) of the 1940 Act and related SEC guidance. *See generally* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666, 17 SEC Docket 319 (Apr. 18, 1979); Dreyfus Strategic Investing & Dreyfus Strategic Income, SEC No-Action Letter (pub. avail. June 22, 1987); Merrill Lynch Asset Management, L.P., SEC No-Action Letter (pub. avail. July 2, 1996).

indices to obtain direct or indirect portfolio exposure to physical commodities.[14] As the CFTC has noted, the benefits of diversifying stock and bond portfolios with physical commodity investments have been widely recognized.[15] Financial research has shown that the risk/return performance of a portfolio can be improved by acquiring uncorrelated or negatively correlated assets, and physical commodity exposure can generally perform that role in a portfolio of other financial assets.[16] For many retail investors, mutual funds that offer physical commodity exposure are the most efficient and cost-effective (and may be the only accessible) means of diversifying their portfolio in that manner. In response to the demand from retail customers for physical commodity exposure, the mutual fund industry has provided investors with access to the asset class by offering physical commodity-focused mutual funds. Whereas mutual funds that offer physical commodity exposure as an asset class are what often come to mind when thinking of funds using "commodity futures, commodity options or swaps," the following discussion clarifies that the universe of mutual funds conducting trading in commodity futures, commodity

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14 Whereas a mutual fund might *prefer*, for any number of reasons, to use futures, options and swaps to pursue certain investment strategies involving equities, bonds and currencies, frequently the most efficient way to pursue a physical commodity-related strategy is through the purchase of derivatives on physical commodities like futures, options and swaps. Investment in underlying physical cash commodities is typically not feasible given custody and other requirements under the 1940 Act.

15 Risk Management Exemption from Federal Speculative Position Limits, 72 Fed. Reg. 66097, 66098 (proposed Nov. 27, 2007).

16 *Id*.

options and swaps—and that could be potentially affected by the proposed rulemaking—is vastly broader.

Intention and Effect of the 2003 Amendments of Regulation 4.5

In 2003, when the CFTC removed the then-current operating restrictions from the Regulation 4.5 CPO exclusion,[17] its intention was "to encourage and facilitate participation in the commodity interest markets by additional collective investment vehicles and their advisers, with the added benefit to all market participants of increased liquidity."[18] The CFTC's goal has been achieved. The volume and liquidity that collective investment vehicles, of which mutual funds are a subset, supply to the commodity markets supports and improves the proper and effective functioning of those markets and facilitates price discovery.[19] Since 2003, mutual funds have increasingly

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17 The 2003 Amendments expanded the scope and use of Regulation 4.5 by eliminating certain operating restrictions on qualifying entities. In particular, the CFTC eliminated the requirement that a qualifying entity use commodity futures or commodity options contracts solely for *bona fide* hedging purposes, although five percent or less of the liquidation value of the qualifying entity's portfolio could be allocated to the aggregate initial margin and premiums necessary to establish non-*bona fide* hedging positions ("**five-percent initial margin test**"). The CFTC also eliminated the language prohibiting a qualifying entity from marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures or commodity options markets ("**marketing restriction**"). Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues, 68 Fed. Reg. 47221 (Aug. 8, 2003) ("**2003 Release**").

18 2003 Release, 68 Fed. Reg. at 47223.

19 Registration under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45172 ,45178 (proposed July 28, 2004) (stating, "We must also recognize the important role that hedge funds play in our markets. Hedge funds contribute to market efficiency and liquidity. They play an important role in allocating investment risks by serving as counterparties to investors who seek to hedge risks." In this regard, mutual fund activity in the markets is not different from hedge funds.). *See also*, David Harris, General Counsel, Nasdaq Liffe Markets, LLC, Remarks at the

participated in, and grown to rely upon access to, the commodities markets, benefiting both those markets and the funds' shareholders.

CFTC Proposed Rulemaking Regarding Regulation 4.5

The CFTC has proposed to revise the currently available exclusion under Regulation 4.5 in order (1) to prevent certain mutual funds from being excluded from registration with the CFTC, (2) to increase its ability to oversee market risk through data gathering and (3) to provide the CFTC with the means to collect data in case of requests from the Financial Stability Oversight Council ("**FSOC**").[20] Accordingly, the CFTC has proposed not merely to reinstitute but to expand the five-percent initial margin test and the marketing restriction that previously applied to funds that

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CFTC Roundtable on Managed Funds (Sept. 19, 2002); Dr. Henry Jarecki, Chairman, Gresham Investment Management, Written Testimony for the CFTC Hearing on Speculative Position Limits in Energy Futures Markets (July 29, 2009).

The 2003 Amendments resulted, in part, from industry comments the CFTC received in conjunction with the CFTC's broader study mandated by Section 125 of the Commodity Futures Modernization Act of 2000 of the CEA, CFTC regulations and conduct of CFTC registrants. In the CFTC's report regarding the study, the CFTC noted that commenters had brought the issue of overlapping regulatory jurisdiction in the managed funds industry to the CFTC's attention. In response, the CFTC planned to hold a roundtable to address "ways in which this regulatory environment may be made less confusing and burdensome." CFTC, Report on the Study of the Commodity Exchange Act and the Commission's Rules and Orders Governing the Conduct of Registrants Under the Act 26 (June 2002), *available at* http://www.cftc.gov/files/opa/opaintermediarystudy.pdf. The study, in addition to the roundtable, informed the CFTC's decision to promulgate the 2003 Amendments. Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors, 68 Fed. Reg. 12622, 12625 (proposed Mar. 17, 2003).

[20] Proposing Release, 76 Fed. Reg. at 7977, 7984.

relied on the Regulation 4.5 exclusion.[21] As proposed, the expanded five-percent initial margin test would include positions in all swap transactions over which the CFTC has jurisdiction, as well as commodity futures and commodity options. As proposed, the expanded marketing restriction would prevent a mutual fund relying on Regulation 4.5 from being marketed as a pool or otherwise as "a vehicle for trading in (*or otherwise seeking investment exposure to) the commodity futures, commodity options, or swaps markets."*[22] As noted above, most mutual funds that do not use commodity futures, commodity options or swaps as part of their principal investment strategy nevertheless have the authority to use these derivatives to some degree in their portfolios for the reasons discussed below. As proposed, the changes might make Regulation 4.5 unavailable to those mutual funds—making those funds subject to regulation

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21 Proposing Release, 76 Fed. Reg. at 7984. Although the CFTC has stated that the proposed Regulation 4.5 changes are related to other regulations it is required to adopt under the Dodd-Frank Act, the National Futures Association ("**NFA**") appears to have generated the rule proposal when in August 2010 it petitioned the CFTC to make almost identical amendments to Regulation 4.5. Letter from Thomas W. Sexton, III, Senior Vice President and General Counsel, NFA, to David Stawick, Office of the Secretariat, CFTC (June 29, 2010), *available at* http://www.nfa.futures.org/news/newsPetition.asp?ArticleID=2491. On August 18, 2009 in a revised letter, the NFA clarified that the rule amendment should apply only to registered investment companies and not to the other entities eligible for exclusion under CFTC Regulation 4.5. Letter from Thomas W. Sexton, III, Senior Vice President and General Counsel, NFA, to David Stawick, Office of the Secretariat, CFTC (August 18, 2010), *available at* http://www.nfa.futures.org/news/newsPetition.asp?ArticleID=3630 ("**NFA Letter**"). For a discussion of the NFA Letter, refer to the August 2010 Dechert LLP OnPoint client alert available at http://www.dechert.com/library/FS_21-08-10-NFA_Petitions_for_ Rulemaking.pdf. On September 17, 2010, the CFTC alerted the public to the NFA's petition and requested comments. 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)[hereinafter "**Notice of Petition"**].

22 Proposing Release, 76 Fed. Reg. at 7989 (emphasis added).

applicable to public commodity pools without any discernable additional protection for retail investors. Depending on what the CFTC considers "marketing"[23] or "investment exposure" for mutual funds, the expanded marketing restriction could potentially include the activities of many, if not the majority of, mutual funds in the industry even if those mutual funds could meet the five-percent initial margin test. Surely, such a drastic, far-reaching consequence could not have been the result the CFTC intended.

We would also question the CFTC's proposed means for meeting its other stated goals for the Regulation 4.5 changes—to facilitate its collection and provision of information to the FSOC, a market risk oversight entity created under Title I of the Dodd-Frank Act.[24] At this point in the FSOC's development, it is not clear that the FSOC would focus on registered investment companies especially as these market participants have not been identified as potential threats to the stability of the country's financial system. As mutual funds and their advisers are already registered entities with the SEC, it is not apparent why dual registration would be necessary for the FSOC to retrieve information regarding a registered investment company's trading or financial position, if the FSOC were interested in this data. The SEC could provide data to the FSOC instead of the CFTC. In addition, the CFTC should be able to collect all the pertinent information it needs for risk assessment from registered investment companies through its already established Form 40 and Form 102 large trader reporting regime (that will soon include swap

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[23] The term "marketing" is not defined in the CEA or CFTC regulations.

[24] Proposing Release, 76 Fed. Reg. at 7977.

positions). Regardless of registration status, all entities trading commodity futures and commodity options above a certain level, including mutual funds, already must make large trader reports to the CFTC.[25]

Retail investors could alternatively invest in public commodity pools whose shares are registered with the SEC under the Securities Act of 1933, as amended ("**1933 Act"**), but which pools are not subject to registration or regulation under the 1940 Act. However, we believe investing through a mutual fund may provide certain advantages over investing in a public commodity pool for retail investors, including: (1) typically lower fees, (2) third-party custody arrangements, (3) trading over the NSCC, (4) DTCC clearing, (5) daily liquidity, (6) daily pricing that is easily and publicly accessible on the internet, (7) transparency, (8) accessibility, and (9) investor protection resulting from regulatory disclosure and substantive operating requirements, including strict limits on leverage, affiliated transactions, portfolio concentration and the holding of security-related issuer securities.[26] When a retail investor buys shares in a mutual fund that invests in commodity futures, commodity options and swaps, the investor is buying a product that is highly-regulated by the SEC under both the 1933 Act and 1940 Act.

The mutual fund industry generally opposes the changes to Regulation 4.5 because the changes would result in the overlay of an additional regulatory regime imposing significant costs on

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[25] 17 C.F.R. § 18.00. The CFTC also has special call power to request additional information from market participants. *See* 14 C.F.R. Part 21.

[26] *See, e.g.*, 15 U.S.C. §§ 80a-17(f), 18(f) and 22.

mutual funds, as well as on fund investment advisers, distributors and other service providers, much but not all of which would be passed on to fund shareholders. Any incremental protection this additional regulation would provide investors seems far outweighed by the expansive scope, duplication and cost of the augmented regulation. Furthermore, mutual funds that invest in commodity futures, commodity options and swaps did not contribute to the recent financial crises, such that more regulation by an additional regulator is warranted or has been demanded by Congress.[27] As a result, it is not apparent that there is a need for additional scrutiny or separate regulatory oversight by the CFTC of mutual funds. In this regard, we note that a substantial majority of the comment letters the CFTC received in response to its Notice of Petition opposed the changes to Regulation 4.5, in whole or in part.[28]

We do not believe the proposed changes are necessary or in the public interest. However, if the CFTC determines to move forward with the proposal, we respectfully suggest that the CFTC coordinate with various industry participants and other regulators of mutual funds, most notably the SEC. The CFTC should carefully consider the costs and burdens of dual registration and

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[27] The investment by registered investment companies in instruments that provide exposure to the commodity futures, commodity options and swaps markets is not an unregulated corner of the market that the Dodd-Frank Act sought to regulate. In fact, the Dodd-Frank Act does not add to or amend in any material way the 1940 Act—evidence that Congress did not see any need for additional regulation of the operations of registered investment companies.

[28] The CFTC received 19 comment letters in response to the Notice of Petition. The CFTC comment letter file is *available at* http://comments.cftc.gov/PublicComments/CommentList.aspx?id=764 (last visited April 8, 2011). The file includes a comment letter from Dechert LLP (October 19, 2010), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26313 &SearchText=.

weigh those costs against any added protection of the public.[29] Applicable CFTC rules (i) need to be made consistent with the SEC's substantive rules and the disclosure forms applicable to mutual funds, (ii) need to allow and account for mutual fund use of offshore subsidiaries to invest in physical commodity futures, commodity options and swaps in accordance with Internal Revenue Service guidance, and (iii) should be appropriately tailored to accomplish the CFTC's stated goals while minimizing the disruption of established practices and products. The CFTC should only proceed with adoption of any portion of the Regulation 4.5 proposal after joint SEC/CFTC consideration of all aspects of the new requirements and additional opportunity for the industry to review and comment on any revised proposals. If the CFTC fails to do so, significant portions of the mutual fund industry will be subject to inconsistent and often conflicting SEC and CFTC regulations with which they will not be able to comply. As a result, affected mutual funds would be forced to close out their positions in commodity futures, commodity options and swaps. The likely result would be market disruption, less liquidity for remaining market participants and harm to the mutual funds' shareholders.

In its Proposing Release, the CFTC asserted that its proposed rulemaking regarding Regulation 4.5, among its other changes regarding CPO and commodity trading advisor ("**CTA**")

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[29] Under Section 15(a) of the CEA, the CFTC is directed to consider the costs and benefits of its regulatory actions. The five broad areas of concern for the CFTC in engaging in a rulemaking are: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of the futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The CFTC is not required to quantify costs and benefits. The CFTC has discretion to give greater weight to any of the factors. 7 U.S.C. § 19(a).

registration, is "consistent with the tenor of the provisions of the Dodd-Frank Act."[30] However, the Dodd-Frank Act does not mandate the proposed changes to Regulation 4.5. As the proposed rulemaking is not subject to the same deadlines as other regulatory changes required by the Dodd-Frank Act, the CFTC has the ability to consider carefully whether to proceed, and if it does proceed to do so only after prudent reflection and investigation and consultation with the SEC and the mutual fund industry.

Potential General Effects of Regulation 4.5 Changes on the Mutual Fund Industry

As proposed, the changes to Regulation 4.5 would have a significant impact on a wide variety of mutual funds and their sponsors, promoters, managers, directors/trustees, officers and distributors in ways neither discussed in nor anticipated by the proposal, and would affect those entities and persons in ways that need to be carefully considered by both the CFTC and the SEC. The proposal would have a number of unintended consequences. The scope and impact of the CFTC's proposed rule changes are significantly broader than necessary to achieve the CFTC's stated purposes: (1) "to stop the practice of registered investment companies offering futures-only investment products without [CFTC] oversight;" (2) to gather market information to improve its oversight functions and (3) to provide information in case of requests from the FSOC.[31]

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30 Proposing Release, 76 Fed. Reg. at 7977.

31 Proposing Release, 76 Fed. Reg. at 7977, 7984.

Challenges in Estimating Costs

Although the mutual fund industry might be able to estimate some of the costs of the proposed rulemaking, presently it cannot arrive at any reasonably definitive estimate of total costs. First, neither the mutual fund industry nor the CFTC will be able to compute costs of the Regulation 4.5 changes until the CFTC resolves issues/problems with the proposal. As detailed further below, in several instances, CFTC regulation of registered investment companies would be duplicative of, or in direct conflict with, SEC regulation. Registering mutual fund trustees/directors as individual CPOs, registering additional individuals in a fund's distribution chain with the NFA, complying with CPO regulations with respect to a fund's wholly-owned offshore subsidiary, sending monthly fund account reports to investors, selling to investors using a full statutory prospectus and statement of additional information instead of using the SEC-approved summary prospectus, selling shares only after receiving a signed subscription agreement, maintaining ledgers of investor information, and revising a mutual fund's prospectus to meet CPO disclosure document requirements could each carry enormous costs. The aggregate costs could be quite staggering. Until there is an ultimate resolution on each of those issues, there can be no reasonable cost estimate of the effect of the proposal.

Challenges Posed by Regulation Timing

Second, the industry and the CFTC will not be able to compute costs of the proposed Regulation 4.5 changes until other related CFTC and SEC rules are promulgated under the Dodd-Frank Act. In this sense, the proposed rulemaking regarding Regulation 4.5 is out-of-order with those other

related actions.[32] As an initial matter, the definition of "swap" is still subject to regulatory definition and could include more or fewer types of OTC products, including foreign exchange forwards that are some of the most commonly used derivatives by mutual funds.[33] In addition, mutual funds will not be able to calculate the proportion of initial margin to net assets for purposes of the five percent initial margin test until there is clarity on what the final rules will be for initial margin posting for both cleared swaps and swaps that remain OTC. Mutual funds do not yet know which of their swap positions would be subject to exchange margin requirements and which will be subject to OTC margin requirements, nor will they know the amounts of those initial margins until the relevant rules under the Dodd-Frank Act are finalized.[34]

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32 *See generally*, Gary Gensler, Chairman, Implementing the Dodd-Frank Act, Remarks Before the FIA Annual International Futures Industry Conference (Mar. 16, 2011) (providing a tentative timeline of Dodd-Frank Act-related CFTC regulation implementation).

33 *See* Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51429 (Aug. 20, 2010) (joint advance notice of proposed rulemaking).

34 The CFTC has proposed a process for reviewing which swaps will be subject to mandatory exchange clearing. Process for Review of Swaps for Mandatory Clearing, 75 Fed. Reg. 67277 (proposed Nov. 2, 2010). The CFTC has also sought public comments regarding segregation rules for margin for cleared swaps and initial margin for uncleared swaps. Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, 75 Fed. Reg. 75162 (Dec. 2, 2010) (advance notice of proposed rulemaking); Protection of Collateral of Counterparties to Uncleared Swaps: Treatment of Securities in a Portfolio Margining Account in Commodity Broker Bankruptcy, 75 Fed. Reg. 75432 (proposed Dec. 3, 2010).

Challenges Presented by the Interpretation of "Marketing" and "Investment Exposure"

Third, the manner in which the CFTC interprets the terms "marketing" and "investment exposure" as used in the Proposing Release could significantly affect the number of funds that could rely on the amended Regulation 4.5 exclusion and thus profoundly affect the costs of the proposed changes. The wording of the proposed marketing restriction, interpreted even in its narrowest sense, stands to capture any mutual fund employing even a modicum of derivatives trading in its portfolio or investing in another fund that does so. The CFTC might adopt a very broad interpretation of "marketing" that encompasses any discussion of investing in or seeking investment exposure to commodity futures, commodity options and swaps. Because mutual funds must disclose their investment strategies and the risks associated with those strategies in their registration statements,[35] they could be disqualified from the Regulation 4.5 exclusion regardless of the amount of or reasons for (*bona fide* hedging or not) commodity futures, commodity options and swaps trading in which they engaged, if the CFTC considers this disclosure to be marketing. Sample strategies that might be disclosed and cause a mutual fund to run afoul of a broad marketing restriction might include seeking absolute returns, reducing

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[35] Form N-1A, Items 4(a), 9(b), and 16(b). Specific disclosure of a mutual fund's policies with respect to commodity investing is also required. 15 U.S.C. § 8(b)(1)(F), Form N-1A, Item 16(c)(1)(v). Recently, the SEC reiterated the importance of specifying derivatives disclosure in shareholder communications. Letter from Barry D. Miller, Associate Director, Office of Legal and Disclosure of the SEC Division of Investment Management, to Karrie McMillan, General Counsel, ICI (July 30, 2010), *available at* http://www.sec.gov/divisions/investment/guidance/ici073010.pdf.

portfolio volatility, following a "life cycle" strategy, hedging inflation, hedging duration risk, hedging currency risk associated with foreign securities trading, equitizing cash, or other goals or strategies. If interpreted too broadly, the definition of "marketing" has the potential to swallow the five-percent initial margin test, making reliance on the rule impossible for any mutual fund investing in futures, options or swaps. If the CFTC is determined to move forward with its proposed changes to Regulation 4.5, we request and suggest that it address the issues discussed above as well as the substantive and regulatory conflicts described below.

Specific Regulatory Conflicts, Duplication and Related Issues

The collateral effects of dual registration could have enormous implications for the substantive regulation of mutual funds and their investment advisers, directors/trustees, officers and associated entities. We recommend that, where aspects of mutual fund governance and operations are already governed by a regulatory regime, the CFTC grant blanket exemptions from its registration requirements and regulations and defer to the already applicable regulatory regime.

Substantive Regulation—Mutual Fund Directors/Trustees & Officers

At the most basic level, the CFTC needs to provide additional clarity as to which persons would be required to register as CPOs – the fund, the sponsor or promoter, the investment adviser, the directors/trustees or others. Under current Regulation 4.5, a registered investment company is both the entity excluded from the definition as a CPO and the pool for whose operation it is

excluded.[36] In other Regulation 4.5 contexts, the excluded CPO is a separate entity managing the pool, and the qualifying entity is the pool.[37] It would be consistent with past CFTC Staff guidance that, if a registered investment company cannot meet the proposed requirements under Regulation 4.5, its adviser or sponsor/promoter would register as the CPO, and the fund would be the pool.[38] However, given the current construction of Regulation 4.5, it is possible that the mutual fund itself would be the registrant. Although the balance of this letter assumes, based on past CFTC Staff guidance, that the mutual fund's adviser or sponsor/promoter would be the registrant if the mutual fund could not meet the test of a qualifying entity under Regulation 4.5, it bears noting that the ambiguity could have enormous implications for deciding which individuals

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[36] Regulation 4.5 provides in pertinent part: "the following persons, and any principal or employee thereof, shall be excluded from the definition of the term 'commodity pool operator' with respect to the operation of a qualifying entity specified in paragraph (b) of this section: (1) an investment company registered as such under the [1940 Act]…(b) For the purposes of this section, the term "qualifying entity" means (1) with respect to any person specified in paragraph (a)(1) of this section, an investment company registered as such under the [1940 Act]." 17 C.F.R. §4.5(a)(1), (b)(1).

[37] *E.g.*, The trustee of an ERISA plan is the excluded entity while the actual ERISA plan is the qualifying entity. 17 C.F.R. §4.5(a)(4), (b)(4).

[38] *See* Commodity Pool Operators and Commodity Trading Advisors; Exemption from Registration and From Subpart 4 for Certain Otherwise Regulated Persons and Other Regulatory Requirements, 49 Fed. Reg. 4778 (proposed Feb. 8, 1984) [hereinafter "**1984 Proposing Release**"].

need to register with the NFA as Principals of the relevant registrant.[39] Registered investment companies are organized as corporations or trusts. Were a registered investment company to be

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[39] "**Principal**" means, with respect to an applicant, a registrant, or a person required to be registered under the CEA:

(1) an individual who is:
  (A) a proprietor of a sole proprietorship;
  (B) a general partner of a partnership;
  (C) a director, president, chief executive officer, chief operating officer, chief financial officer or a person in charge of a business unit, division or function subject to regulation by the CFTC of a corporation, limited liability company or limited liability partnership; or
  (D) a manager, managing member or a member vested with the management authority for a limited liability company or limited liability partnership; or

(2) an individual who directly or indirectly, through agreement, holding companies, nominees, trusts or otherwise:
  (A) is the owner of 10% or more of the outstanding shares of any class of an applicant or registrant's stock;
  (B) is entitled to vote 10% or more of any class of an applicant or registrant's voting securities;
  (C) has the power to sell or direct the sale of 10% or more of any class of an applicant or registrant's voting securities;
  (D) has contributed 10% or more of an applicant or registrant's capital;
  (E) is entitled to receive 10% or more of an applicant or registrant's net profits;
  (F) or has the power to exercise a controlling influence over an applicant or registrant's activities that are subject to regulation by the CFTC; or

(3) an entity that:
  (A) is a general partner of a partnership;
  (B) is the direct owner of 10% or more of any class of an applicant or registrant's securities; or
  (C) has directly contributed 10% or more of an applicant or registrant's capital unless such capital contribution consists of subordinated debt contributed by:
    (i) an unaffiliated bank insured by the Federal Deposit Insurance Corporation;
    (ii) a United States branch or agency of an unaffiliated foreign bank that is licensed under the laws of the United States and regulated, supervised and examined by United States government authorities having regulatory responsibility for such financial institutions; or
    (iii) an insurance company subject to regulation by any State. NFA Registration Rule 101(t).

considered the registrant, its officers and board members would need to register as Principals, as would certain individuals and entities with significant interests in the fund.[40] Whereas mutual fund officers are typically employees of the adviser, an officer of a fund may not hold the same position at the adviser. For example, the president of a mutual fund may not also be the president of the adviser. In the case of independent directors/trustees, they are not affiliated with the fund's adviser.[41]

It is possible that all trustees and directors of mutual funds could be personally required to register as CPOs, including the disinterested or independent directors/trustees. All directors of a fund's offshore subsidiary could also be required to register as CPOs. Furthermore, because every registered CPO must have a registered associated person ("**AP**"),[42] a CPO trustee or director could be required to register as an AP and meet the NFA's AP proficiency testing, fingerprinting and training requirements. The CFTC Staff has previously taken the 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.[43] Although limited relief has been granted in the

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40 Among other ownership tests under the NFA definition of a Principal, an individual who directly or indirectly owns 10% or more of the outstanding shares of any class of a registrant's stock or an entity that is the direct owner of 10% or more of any class of a registrant's securities is a Principal of the registrant. NFA Registration Rule 101(t)(2)(A), (3)(B).

41 *See* 15 U.S.C. § 2(a)(3), (19).

42 NFA Bylaw 301.

43 The individuals would need to register as CPOs under Section 4m(1) of the CEA. *See, e.g.*, CFTC No-Action Letter No. 97-73 (Aug. 20, 1997) (granting no-action relief to directors of a fund who

past to independent directors and trustees of certain funds, that relief has been subject to conditions that would be untenable for directors and trustees of registered investment companies, because the applicable CFTC Staff letters have required, among other things, that in order to qualify for the relief, the directors/trustees delegate to a registered CPO all responsibility for the operation of the pool, including the responsibility for hiring and firing the CTA (the equivalent of the adviser or subadviser to a registered investment company).[44] Under Section 15 of the 1940 Act, making determinations as to the hiring and firing of fund service providers that provide analogous services as CTAs is possibly the most important responsibility for mutual fund

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did not register as CPOs where the directors delegated the fund's operations, solicitation and supervision to a registered CPO and the registered CPO managed the fund); CFTC No-Action Letter No. 09-39 (Jul. 30, 2009) (granting no-action relief to trustees of a commodity pool organized as a trust who did not register as CPOs where the trustees had no authority to perform CPO functions and a separate registered CPO performed all CPO functions for the trust); CFTC No-Action Letter No. 10-06 (Mar. 29, 2010) (granting no-action relief to independent trustees of a commodity pool organized as a trust who did not register as CPOs where the independent trustees had no authority to perform CPO functions, the independent trustees were appointed solely to meet certain audit committee independent trustee membership requirements and a separate registered CPO was authorized to perform all CPO functions).

44 While the letters did not typically specify that the director could not be involved in hiring or firing the CTA, the CFTC Staff has traditionally viewed this as one of the core functions of the CPO. *See, e.g.*, 1984 Proposing Release, 49 Fed. Reg. at 4780 (noting that, in determining who is the CPO of a given pool, "the staff typically looks at . . . 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 [futures commission merchant].").

trustees/directors.[45] Fund board members cannot recuse themselves from the application of this statutory responsibility in order to avoid CPO registration.

Requiring individual board members to register as CPOs would be inappropriate and has the potential to upset significantly mutual fund governance practices. A mutual fund's board provides an investor protection and oversight function that is mandated by the 1940 Act and has been recognized by Congress[46] and the U.S. Supreme Court.[47] Mutual fund independent directors and trustees do not solicit investors or make investment decisions, but rather have oversight authority to ensure that the assets of the fund are being managed in the interests of fund shareholders. Currently, directors'/trustees' actions are subject to state law duties of care and loyalty. So long as directors/trustees appropriately exercise their fiduciary duties to fund shareholders, their liability is limited and their actions are protected by the business judgment

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45 Section 15(c) of the 1940 Act provides that: "[i]t shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company." 15 U.S.C. §15.

46 As the House of Representatives has reported: "[d]irectors of the fund, including the independent directors, have an important role in the management fee area. A responsible determination regarding the management fee by the directors including a majority of disinterested directors is not to be ignored." S. Rep. No. 91-184 (1970), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4903.

47 "Recognizing that the relationship between a fund and its investment adviser was 'fraught with potential conflicts of interest,' the [1940 Act] created protections for mutual fund shareholders…Among other things, the [1940 Act] required that no more than 60 percent of a fund's directors could be affiliated with the adviser and that fees for investment advisers be approved by directors and the shareholders of the fund." *Jones v. Harris Associates, L.P.*, No. 08-586, 2010 WL 1189560 (U.S. March 30, 2010) (quoting *Daily Income Fund v. Fox*, 464 U.S. 523, 536 (1984)).

rule. On the other hand, registered CPOs must accept joint and several liability for any violation of the CEA or CFTC regulations.[48] Requiring fund independent directors and trustees to register as CPOs and to subject themselves to liability under the CEA could well discourage qualified persons from serving as mutual fund independent directors and trustees. Furthermore, any additional investor protection that registration of board members as CPOs would provide seems far outweighed by the additional burdens and costs it would impose.

Substantive Regulation—Funds of Funds

Many mutual fund products are structured as funds of affiliated funds and are managed to provide asset allocation and diversity of investments to those saving for retirement. This structure is specifically permitted by Section 12(d)(1)(G) of the 1940 Act.[49] However, funds of funds that do not themselves invest in commodity futures, commodity options or swaps could nevertheless be subject to regulation as operating commodity pools since in other contexts the CFTC has taken the view that a fund that invests more than 5% of its assets in a commodity pool is itself a commodity pool.[50] Applying the 5% standard in the mutual fund context would likely have the

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48 In some instances where the CFTC has granted no-action relief for fund trustees from CPO registration, a condition of the relief has been that the board of trustees and the registered CPO of the fund continue to accept joint and several liability for any violations of the CEA. *See, e.g.*, CFTC No-Action Letter No. 97-73 (Aug. 20, 1997).

49 15 U.S.C. § 80a-12(d)(1)(G).

50 *See, e.g.*, 17 C.F.R. § 4.13(a)(3); *compare* CFTC Interpretative Letter 84-2 (denying relief to a limited partnership that could commit up to 10% of its assets for the purchase of interests in commodity pools), *with* CFTC Interpretative Letter 86-22 (granting relief to a limited partnership

perverse result of discouraging funds of funds from gaining exposure to alternative investments through underlying funds in order to avoid CPO regulation. In addition to the 5% test for an investment in an underlying commodity pool, the marketing restriction could also subject a fund of funds to CPO regulation if it were considered a vehicle for trading in "(or otherwise seeking investment exposure to) the commodity futures, commodity options, or swaps markets."[51] The potential consequences of the proposed Regulation 4.5 amendments for funds of funds is an illustration of the extent of the unintended reach of the proposals.

Substantive Regulation—Associated Person Registration and Compliance

Large segments of the mutual fund distribution chain could be subject to registration, proficiency testing, fingerprinting and regulatory requirements as APs.[52] Under current NFA rules, natural person associates of a CPO and their supervisors must register with the NFA and satisfy certain proficiency requirements as APs. The registration requirements apply to any person in a supervisory chain-of-command and not only to persons who directly supervise the solicitation of

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that would commit no more than 5% percent of its assets for the purchase of interests in commodity pools).

51 Proposing Release, 76 Fed. Reg. at 7989.

52 An AP of a CPO is "any natural person who is associated…with a commodity pool operator as a partner, officer, employee, consultant, or agent (or any natural person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation of funds, securities, or property for a participation in a commodity pool or (ii) the supervision of any person or persons so engaged." 17 C.F.R. § 1.3(aa).

orders, customers or funds.[53] The definition of AP is potentially broad enough to apply to some persons serving as dual representatives of mutual funds and affiliated and unaffiliated brokerage firms that sell mutual fund shares. To the extent that individuals cannot qualify for an available exemption, they would be subject to AP registration and compliance. Under current CFTC and NFA rules and guidance, there are a handful of narrow exemptions available. One exemption is available to individuals who are associated with a registered broker-dealer, who are registered with the Financial Industry Regulatory Authority ("**FINRA**") in the capacity of a registered representative, registered principal, limited representative, or individual who supervises any person or persons so engaged, and who have satisfied the proficiency requirements; however, in order to qualify for the exemption, the individual must limit activity to the solicitation of participations in a commodity pool and not engage in any other activity subject to CFTC regulation.[54] Another limited exemption is available to individuals who are chief operating officers, general partners or other persons in the supervisory chain-of-command, provided the relevant individual is already registered as a Principal of the firm, the CPO engages in a limited amount of commodity interest related activity, and other conditions are met.[55] Exemptions from

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53 7 U.S.C. § 6k(1)-(3). The NFA has provided some guidance on whom in the supervisory chain-of-command must register as an AP, but the guidance has not been definitive because of the myriad number of organizational structures of registrants. *See* NFA Interpretive Statement Regarding the Scope of the Term "Supervision" in the Associated Person Registration Requirement (Aug. 14, 1980).

54 17 C.F.R. § 3.12(h)(1)(ii).

55 17 C.F.R. § 3.12(h)(1)(iii).

the proficiency testing requirements are available in limited circumstances as well.[56] Depending on the number of individuals who might be involved, AP registration could involve enormous costs and burdens. If the costs and burdens on unaffiliated brokerage firms are too great, it may prompt these intermediaries to cease or limit the offering of shares of affected mutual funds, thereby limiting retail investor access to this important investment option.

Substantive Regulation—Recordkeeping

CFTC recordkeeping requirements currently provide that a CPO must maintain a ledger or other equivalent record for each participant in the pool, which is a record of each investor's name, address and all funds, securities or other property the pool has received or distributed to the investor.[57] Applying this requirement to a mutual fund could severely restrict the common industry practice of allowing fund investors to hold their shares through omnibus accounts and Networking Level 3 accounts maintained by financial intermediaries, such as broker-dealers and banks. If the relevant financial intermediaries are not considered the "investors" for purposes of this recordkeeping requirement, either the shares would not be able to be held in omnibus or Networking Level 3 accounts or the omnibus and Networking Level 3 accounts would need to be "pierced." Omnibus accounts are an arrangement that provides for greater ease of management

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[56] *See* NFA Rule 401 and 402, *see also* NFA Interpretive Notice 9018: Registration Rule 402: CPOs of Pools Trading Primarily in Securities (Aug. 1, 1992, revised Dec. 10, 2007). The waiver requirements for a CTA are almost the same. *See* NFA Interpretive Notice 9022: Registration Rule 402: CTAs Trading Primarily in Securities (Sept. 21, 1993; revised Dec. 10, 2007).

[57] 17 C.F.R. §4.23(a)(4).

of investor accounts. Mutual fund shares are held in millions of omnibus accounts.[58] Piercing omnibus accounts or discontinuing the practice of using omnibus accounts for mutual funds that invest in commodity futures, commodity options and swaps would make mutual fund distribution impossible with no ascertainable additional shareholder protection.

In addition, under current CFTC rules and absent CFTC Staff no-action relief, a CPO must maintain required books and records for the commodity pool at its main business office for a five-year period, the first two years of which the records must be "readily accessible."[59] The 1940 Act and rules thereunder also impose recordkeeping requirements on mutual funds and their advisers; however, Rule 31a-3 recognizes that required mutual fund records may be maintained by other entities so long as the maintenance arrangement meets certain conditions.[60] Moving records to and maintaining records at a dual registrant's main business office to comply with CFTC rules could be a Herculean task that involves significant costs with no ascertainable additional shareholder protection.

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58 When the SEC adopted redemption fee rules in 2006 that related to omnibus accounts, commenters reported that hundreds of thousands of accounts could qualify as being held by financial intermediaries. Mutual Fund Redemption Fees, 71 Fed. Reg. 58257, 58264 n.62 (Oct. 3, 2006).

59 17 C.F.R. § 4.23 and 17 C.F.R. § 1.31.

60 17 C.F.R. §270.31a-3.

Under current CFTC rules, shareholders in mutual funds subject to CFTC regulation would be given access to pool trading information and other proprietary information.[61] If pool trading information captures a mutual fund's entire portfolio, it would raise portfolio holding disclosure and possible front-running issues and could allow competitors and others to have daily access to fund portfolio information simply by purchasing fund shares and demanding their rights under CFTC rules. This could lead to investors trying to "front run" fund trading in certain securities, taking advantage of anticipated price movements in assets susceptible to these activities by getting in front of fund trades. Having this information could also allow a competitor to reverse engineer a mutual fund's quantitative strategy. Mutual funds must currently set and disclose policies regarding how often and to whom they divulge their portfolio holdings.[62] They are required to disclose their holdings twice yearly in shareholder reports[63] and within 60 days of quarter end for the first and third fiscal quarters on Form N-Q.[64] Many mutual funds disclose their portfolio holdings more frequently, such as monthly. Mutual funds are generally prohibited from selectively disclosing their portfolio holdings information in contravention of their fund

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61 17 C.F.R. § 4.23. Information that must be made available to commodity pool participants for inspection and copying include, but is not limited to, the pool's itemized daily record of each commodity interest transaction of the pool, a record showing all receipts and disbursements of money, securities and property and copies of confirmations. 17 C.F.R. § 4.23(a)(1), (2) and (7).

62 Form N-1A, Item 16(f).

63 17 C.F.R. § 270.30e-1 and Form N-CSR, Item 6.

64 17 C.F.R. §270.30b1-5 and Form N-Q, General Instruction A.

policies.[65] Therefore, mutual funds disclosing portfolio information to one shareholder under CFTC regulations would arguably be required to disclose publicly this information to all of their shareholders.

Substantive Regulation—Reporting to Investors

Dual registrants would be required under current CFTC rules to distribute monthly reports to pool participants. These reports include a statement of operations and statement of changes in net assets. In addition, the monthly account report must discuss material business dealings between the pool and its service providers that have not been previously disclosed.[66] Given that mutual funds publicly disclose their NAV daily, and provide semi-annual reports to investors that provide the same information as the account statement,[67] monthly reports would be unnecessary and would only serve to increase fund operating expenses.[68] Monthly reporting requirements

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65 Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 69 Fed. Reg. 22300, 22306 (Apr. 23, 2004).

66 17 C.F.R. § 4.22.

67 17 C.F.R. §270.30b1-1.

68 In bears noting that, the CFTC has recently approached this problematic issue in proposed rules regarding commodity-index and actively-managed futures exchange-traded funds ("**Commodity ETFs**") and their sponsors, directors, and/or trustees. If adopted, the proposed rules would exempt Commodity ETFs from the CFTC periodic account statement distribution requirements. Rather than distributing a monthly account statement to each pool participant, Commodity ETFs would be permitted to maintain each account statement on their website for at least 30 days. Mutual funds, like Commodity ETFs, also have a constantly changing investor base, making distribution of monthly reports both costly and unnecessary, especially given the fact that mutual funds already make publicly available their NAV and provide semi-annual reports to investors. Commodity Pool Operators: Relief from Compliance with Certain Disclosure, Reporting and Recordkeeping Requirements for Registered CPOs of Commodity Pools Listed for Trading on a

could also impose major operational hurdles and additional costs for shareholders that hold mutual fund shares in omnibus accounts by introducing additional operational requirements on intermediaries that are not necessarily equipped to meet these requirements.

Disclosure Requirements—Delivery

In addition to the conflicts and inconsistencies between the two regimes of substantive regulation, a dual registrant would face additional disclosure obligations that would increase fund operating costs paid by investors, but that would not contribute to investor protection. Application of current CFTC disclosure requirements to mutual funds would result in multiple disclosure conflicts and problems that could make it impossible or significantly more burdensome and costly for funds to do business as a dual registrant. While CFTC disclosure requirements serve the same general purposes of investor protection and full and fair disclosure as are served by SEC requirements, the two disclosure schemes are different and sometimes contradictory in several respects.

As an initial matter, compliance with CFTC and NFA disclosure delivery requirements would fundamentally affect how mutual funds sell their shares. Under CFTC regulations, a CPO must deliver a disclosure document to a prospective participant no later than the time at which it delivers a subscription agreement to such participant.[69] A CPO may not accept funds from a

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National Securities Exchange; CPO Registration Exemption for Certain Independent Directors or Trustees of These Commodity Pools, 75 Fed. Reg. 54794 (proposed Sept. 9, 2010) [hereinafter "**ETF Proposal**"].

69 17 C.F.R. § 4.21(a)(1).

prospective participant unless the CPO first receives from the participant a signed and dated acknowledgment that the participant received the disclosure document. If the disclosure document is delivered 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.[70] In contrast, under the 1933 Act, sales of a mutual fund's securities must be accompanied or preceded by the fund's then-currently effective prospectus.[71] While investors often receive the prospectus before making an investment decision, it is customary for the prospectus to be sent with the confirmation which can be sent as late as three days after the trade date (T+3), which satisfies the 1933 Act prospectus delivery requirements.[72] There is no SEC requirement that a mutual fund receive a signed acknowledgement from an investor that the investor received the prospectus before the fund may accept a purchase order. The SEC permits electronic communication of regulatory materials, including the prospectus as well as other required reports, subject to the basic requirements of notice, access and evidence of delivery.[73]

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70 17 C.F.R. § 4.21(b).

71 15 U.S.C §77a-5(b)(2).

72 *Id*.

73 If adopted, the proposed rules in the ETF Proposal would exempt Commodity ETFs from the CPO disclosure document delivery requirements and, instead, require them to make their disclosure documents readily accessible on their website, inform prospective investors of their availability, and direct selling agents to do the same. The ETF Proposal would be a good starting point for the CFTC to consider issues related to mutual funds as differences between mutual funds and Commodity ETFs do not justify more burdensome treatment of mutual funds.

In addition, a Statement of Additional Information ("**SAI**") would have to be delivered with every prospectus of a dual registrant. NFA Rule 2-35 states that "the CPO of a commodity pool required to register its securities under the [1933 Act] must deliver (or cause to be delivered) a separate [SAI] to a prospective participant prior to accepting or receiving funds from the prospective participant." This SAI must contain: (i) disclosures that are not included in the disclosure document, but are required by the SEC; (ii) statements that expand on or explain the disclosures in the disclosure document; and (iii) any other relevant information.[74] Under applicable SEC rules, mutual funds are required to provide their SAI only upon request from an investor.[75]

The consequences of changing the mutual fund disclosure delivery requirement in response to CFTC and NFA rules are that it would likely preclude the offer and purchase of these mutual fund shares on certain platforms, increase transfer agency burdens and costs, which are ultimately borne by fund shareholders, and unnecessarily delay initial investments. As discussed further below, the SEC has recently studied the issue of prospectus delivery and come to different conclusions regarding the need to deliver the full statutory prospectus to investors. Mutual fund investors frequently purchase shares through intermediaries such as broker-dealers and hold those shares in omnibus accounts. Investors also purchase mutual fund shares in retirement plans. In these arrangements, intermediaries do not have the operational systems in place to support the

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74 NFA Compliance Rule 2-35.

75 17 C.F.R. §230.498(e)(1).

CFTC disclosure delivery requirements. If a mutual fund is part of a 401(k) or 403(b) program as an investment choice or default investment, such as an asset allocation fund that invests in commodity futures, commodity options and swaps, the disclosure document delivery requirement could hamper and delay investment. Fund exchange privileges would also be adversely impacted because the full commodity pool prospectus delivery process would have to be carried out for an investor to move between mutual funds in the same fund family. All of the foregoing is unnecessary, duplicative and/or conflicting, and would significantly and adversely affect mutual fund shareholders.

Disclosure Requirements—SEC Summary Prospectus Rule

This divergence between the SEC summary prospectus rule and CFTC commodity pool disclosure delivery requirements could preclude a dual registrant from selling mutual fund shares using a summary prospectus. The SEC recently revised and rearranged Form N-1A, requiring that mutual funds provide a summary section at the beginning of their statutory prospectus and permitting the use of a summary prospectus for selling.[76] In concluding that a summary prospectus could be provided to mutual fund investors with a statutory prospectus only having to be made available, the SEC studied and considered retail investor needs as well as increased investor access to the internet.[77]

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[76] 17 C.F.R. §270.498. The summary prospectus may be subject to further changes under the Dodd-Frank Act.

[77] Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 Fed. Reg. 4546 (Jan. 26, 2009).

If used, the summary prospectus must follow the relevant items in the form exactly without additional disclosure.[78] CFTC rules contemplate a primary disclosure document comparable to an SEC statutory prospectus. However, CFTC rules do not include anything comparable to the SEC's Rule 498 summary prospectus regime. The industry recently made significant investments in architecture and systems in order to implement the summary prospectus.

The issue cannot be readily solved by simply permitting a dual registrant to sell mutual fund shares using a summary prospectus. Assuming a dual-registrant could sell using a summary prospectus, to the extent items required in a CPO disclosure document would be in addition to disclosure required in the summary section of a Form N-1A statutory prospectus, a fund simply would not be able to comply with both disclosure regimes. The summary prospectus includes a cover page and the following disclosure of key items of information about the fund: the principal investment objectives and risks, fee table, fee example table, performance chart and table, disclosure regarding the adviser and subadvisers, description of how fund shares are purchased and sold, certain tax information and disclosure regarding financial intermediary compensation.[79] Summary prospectuses are not permitted to include additional information not explicitly called for under Rule 498. While the additional disclosure could appear in the fund's statutory prospectus, addressing mutual fund disclosure items in the summary and reserving CPO

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78 Form N-1A, General Instruction C.3(b).

79 *Id*.

disclosure document items for the statutory prospectus could be confusing or misleading to investors.

Disclosure Requirements—Document Contents

In order to comply with CPO disclosure document content requirements, a mutual fund would have to add the following –at times—conflicting disclosures. Some of the primary conflicting disclosure document content issues are as follows:[80]

COMMODITY POOL	MUTUAL FUND	ANALYSIS
A CPO is required to provide performance information for each other similar pool and account it operates and explain the material differences between the offered pool and the other pools and accounts.[81]	A mutual fund is only permitted to disclose the performance of other pools/funds in limited circumstances, and even then only if they are substantively similar to the fund itself.[82]	Absent no-action relief, this is a direct conflict.

[80] As previously stated, we request, as a general matter, that the CFTC defer to the regulatory framework already applicable to mutual funds.

[81] 17 C.F.R. §§ 4.25(c)(2) and (a)(3).

[82] *Nicholas-Applegate Mutual Funds*, SEC No-Action Letter (pub. avail. Aug. 6, 1996).

COMMODITY POOL	MUTUAL FUND	ANALYSIS
A commodity pool must include the rate of return presented on a monthly basis for the last five years and year-to-date.[83]	Mutual funds are required to provide their average annual returns on a calendar year basis for the last ten years, if available.[84]	If the intention is to present one set of returns, this is a direct conflict. Moreover, if an additional chart or graph showing monthly returns were included adjacent to Form N-1A, Item 4 disclosure, it would conflict with the summary section/prospectus limit on content.
Commodity pool performance amounts are required to be net of all fees, expenses and allocations to the CPO.[85]	Mutual fund performance disclosures in the bar chart required by Form N-1A do not reflect sales loads and account fees. However, other performance disclosures are net of fees.[86]	These different measurements appear to be in conflict with each other and could confuse investors.
A commodity pool must include the largest monthly drawn-down (loss) in the last five years and year-to-date;[87] and include the worst peak-to-valley draw-down for the same time periods.[88]	A mutual fund is required to disclose the highest and lowest return for a quarter during the last 10 calendar years or for the life of the fund. If the fund's fiscal year is other than a calendar year, it must disclose the year-to-date return as of the end of the most recent quarter.[89]	These different requirements would be an additional disclosure burden and could confuse investors. Moreover, if the information appeared adjacent to Form N-1A, Item 4 disclosure, it would conflict with the section/summary prospectus limit on content.

83 17 C.F.R. § 4.25(a)(1)(i)(H).

84 Form N-1A, Item 4(b)(2)(ii)-(iii).

85 17 C.F.R. § 4.25 (a)(1)(i).

86 Form N-1A, Item 4(b)(2), Instruction 1.

87 17 C.F.R. §§ 4.25 (a)(1)(i)(F), 4.10(k).

COMMODITY POOL	MUTUAL FUND	ANALYSIS
Commodity pool performance must include the aggregate gross capital subscriptions to the pool.[90]	There is no comparable mutual fund disclosure requirement.	If this additional information appeared adjacent to Form N-1A, Item 4 disclosure, it would conflict with the section/summary prospectus limitation on content. In addition, for an open-end fund that continuously offers and redeems its shares, the aggregate gross capital subscriptions change daily. The measurement is meaningless to fund investors, as subscriptions will frequently be offset, in whole or in part, by redemptions.

88 17 C.F.R. §§ 4.25 (a)(1)(i)(G), 4.10(l).

89 Form N-1A, Item (4)(b)(2)(iii).

90 17 C.F.R. § 4.25 (a)(1)(i)(D).

COMMODITY POOL	MUTUAL FUND	ANALYSIS
A commodity pool is required to provide a break-even point which is the trading profit the pool must realize in the first year of a participant's investment in order to recoup all fees and expenses. This break-even point must be expressed both as a dollar amount and as a percentage of the minimum unit of initial investment and must assume redemption of the initial investment at the end of the first year of investment.[91]	A mutual fund is required to provide an Example of Fund Expenses that shows the dollar amount of expenses an investor will pay after 1, 3, 5 and 10 years of investment assuming a 5% rate of return.[92]	While these two requirements are similar, this would be an additional disclosure requirement as the comparable mutual fund disclosure is a different measurement. If the information appeared adjacent to Form N-1A, Item 3 disclosure, it would conflict with the summary section/prospectus limit on content. Although CPO disclosure rules do not mandate an exact order of items, the requirement that the break-even analysis should appear in the "forepart" of the document may conflict with the SEC's summary prospectus requirements.

91 17 C.F.R. §§ 4.24 (d)(5), 4.10(j).

92 Form N-1A, Item 3.

COMMODITY POOL	MUTUAL FUND	ANALYSIS
On its disclosure document cover page, a CPO is required to provide a cautionary statement to the effect that the CFTC has not passed on the merits of participating in the pool or on the adequacy or accuracy of the disclosure document. It must also provide boiler-plate risk disclosure statement(s) addressing the general risk of trading commodity interests and, if applicable, the risks of investing in a pool that trades foreign commodity interests, the risk that losses may not be limited to the amount of an investor's contribution and/or the risk of investing in a pool that engages in off-exchange foreign currency trades.[93]	This would be an additional disclosure requirement to the mutual fund's cover page under applicable SEC rules.	The additional information could not appear on the mutual fund's summary prospectus cover page under applicable SEC rules. In addition, the SEC has stated that boiler-plate all-capital letter risk disclosure would violate the Plain English disclosure rule under the 1933 Act.[94] In addition, the underlined text does not apply to mutual fund investments.

We submit that the comprehensive disclosure requirements under the 1933 Act and 1940 Act have likely been helpful in allowing investors to understand and evaluate fully and clearly the potential risks and costs of investing in mutual funds that invest in commodity futures, commodity options and swaps. Given the similarities between general *types* of mutual fund and

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93 17 C.F.R. § 4.24 (a)-(b) (emphasis added).

94 *See* Plain English Rule, 17 C.F.R. § 421(d) ("Using all capitalized letters for the legends does not give them proper prominence. Rather, it makes them hard to read." Plain English Disclosure, SEC Release No. 33-7497 at 11 (Jan. 28, 1998).

CPO disclosure (*i.e.*, showing amount and effect of fees on an investor's returns, calling out especially disappointing returns as well as standout reporting periods), a serious question arises as to whether requiring CPO disclosure document items in a dual-registrant's prospectus would materially augment investor protections, keeping in mind that much of the cost of additional and different disclosure requirements would be passed on to fund investors who arguably do not need additional or different disclosure to protect them and who likely would be confused by requirements such as two different performance presentations.

Use of Offshore Subsidiaries

Changes to the exemptions available to mutual fund offshore subsidiaries would increase the cost of running mutual funds that use these vehicles. Currently, the Internal Revenue Code ("**Code**") and Internal Revenue Service ("**IRS**") guidance effectively require mutual funds that want to acquire exposure to physical commodities through certain physical commodity-linked instruments (*e.g.*, futures, options and swaps) to invest up to 25% of their assets in the equity of a wholly-owned offshore subsidiary that in turn invests using these instruments. Under Subchapter M of the Code, direct investments in physical commodity futures, options and swaps do not generate "qualifying income" for registered investment companies. In order to maintain their tax status as registered investment companies, mutual funds must derive 90% of their investment income from qualifying income, which would limit a fund's investment in physical commodity

futures, options and swaps.[95] Many mutual funds have requested and received private letter rulings in which the IRS concluded that dividends received on an investment in the equity securities of, and "Subpart F" income attributable to, a subsidiary investing primarily in physical commodity-linked derivatives would constitute "qualifying income."[96] Thereafter, many mutual funds, including physical commodity-based mutual funds, began investing in these derivative instruments through a wholly-owned offshore subsidiary ("**Subsidiary**"). In addition to permitting registered investment companies indirectly to derive more than 10% of their income from physical commodity futures, options and swap trading, direct purchases of physical commodity futures, options and swaps through a Subsidiary are generally more cost effective for investors than entering into physical commodity-linked notes.

Currently, a Subsidiary is a pool for which its operator is eligible for an exemption from CPO registration under Regulation 4.13(a)(4) as its shares are exempt from registration under the 1933 Act and its only participant is the parent registered investment company, which is a qualified eligible participant.[97] In conjunction with the Regulation 4.5 changes, the CFTC has proposed to revoke the Regulation 4.13(a)(4) exemption.[98]

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95 26 U.S.C. § 851(b).

96 *See, e.g.*, I.R.S. Priv. Ltr. Rul. 200822010 *3(Feb. 12, 2008), I.R.S. Priv. Ltr. Rul. 200840039 *8(June 13, 2008) and I.R.S. Priv. Ltr. Rul. 200842014 *11(July 17, 2008).

97 17 C.F.R. §4.13(a)(4).

98 Proposing Release, 76 Fed. Reg. at 7985.

Mutual fund Subsidiaries should be allowed to continue to qualify for a CPO exemption such as the Regulation 4.13(a)(4) exemption. Absent an available exemption, this change would require the registered investment company adviser to comply with CFTC disclosure and substantive regulation with respect to the Subsidiary as well as the registered investment company, which would be duplicative and costly and provide no benefit to the recipient of the disclosure, as in many respects a Subsidiary is effectively the alter ego of its mutual fund parent.[99] Private letter rulings from the IRS, along with SEC requirements under the 1940 Act, apply substantial investor protections to Subsidiaries. Under the private letter rulings, in order for the income that a Subsidiary generates to constitute "qualifying income," it must represent that its investing activities meet the requirements of Section 18(f) of the 1940 Act that prohibit the issuance of senior securities. The Subsidiary must meet the same leverage and asset coverage restrictions applicable to a registered investment company. This constraint on a Subsidiary's activities addresses arguably the riskiest aspect of investing in commodity futures, commodity options and swaps—the embedded leverage in those contracts. Furthermore, Section 48(a) of the 1940 Act prohibits a registered investment company from engaging indirectly in any act that would otherwise directly violate the 1940 Act or the rules thereunder. Accordingly, a Subsidiary would be prohibited from undertaking any action that would cause its parent fund to violate the 1940 Act. The NFA Letter cited a concern for lack of transparency for registered investment company

[99] CFTC Regulation 4.7 exemptive relief may be available to a registered investment company adviser that applies for it with regard to the Subsidiary. However, this relief would not address all of the resulting duplication. 17 C.F.R. § 4.7.

investors regarding a Subsidiary's holdings as a reason to require registration.[100] This concern is unfounded since mutual fund disclosure documents describe the investment activities of their Subsidiaries and many mutual funds consolidate their Subsidiaries' balance sheets with their own for shareholder reporting purposes.

Simply retaining Regulation 4.13(a)(4) for Subsidiaries would not go far enough. If the proposed amendments to Regulation 4.5 are adopted, the marketing restriction could still prompt the parent mutual fund sponsor to have to register as a CPO as the parent fund may be considered "a vehicle for trading in (or otherwise seeking investment exposure to) the commodity futures, commodity options, or swaps markets" due to its disclosure of indirect exposure to the same. Some mutual funds establish Subsidiaries out of an abundance of caution for meeting the Subchapter M qualifying income test even when they plan to use very limited commodity futures, commodity options and swaps, and would expect not to exceed the five percent initial margin test. However, under the marketing restriction, those mutual fund sponsors could nevertheless be required to register as CPOs with respect to operating the parent fund simply because the parent fund has a Subsidiary.

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[100] NFA Letter, *supra* note 21.

Employ a Comprehensive Regulatory Approach

Mutual fund regulation is a well-settled area. The robust and comprehensive statutory requirements of the 1940 Act and the regulations promulgated thereunder have successfully served the best interests of mutual fund investors currently invested in over 9,000 funds for 70 years (including since the 2003 Amendments). The excessive burdens on mutual funds that would result from complying with a revised Regulation 4.5 would not be justified by the reasons specified in the Proposing Release.

The proposed rule change is not mandated by the Dodd-Frank Act and is therefore not subject to the same short deadlines for rulemaking. Considering that the SEC and CFTC are under considerable time pressure to meet Dodd-Frank Act deadlines and budgetary pressure,[101] and—as discussed above—that the full effect of the proposed Regulation 4.5 changes cannot be assessed until other relevant Dodd-Frank Act mandated regulations have been completed, the CFTC should not proceed until after the adoption of such rules. In so doing, the CFTC should carefully

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[101] Gary Gensler, Chairman, CFTC, Remarks before the Institute of International Bankers (Oct. 21, 2010)("Some have asked whether the CFTC is moving too quickly. That statute, however, has clear deadlines that we have been directed to meet."); Bart Chilton, Commissioner, CFTC, Statement on Position Limits, "Keeping Promises," (Dec. 2, 2010)(expressing concern for meeting the statutory deadline for position limit regulations); Michael V. Dunn, Commissioner, CFTC, Opening Statement at the Public Meeting on Proposed Rules Under Dodd-Frank Act (Jan. 26, 2011)("the CFTC today faces a severe budget crisis…We lack the staff and resources necessary to both implement Dodd-Frank and continue to fulfill our pre-Dodd-Frank duties."); Charles Abbott, Ann Saphir and Jonathan Spicer, "CFTC to Miss Swap Regulatory Deadlines—Chairman" REUTERS (Mar. 16, 2011).

consider the implications of rulemaking and the impact on mutual funds, their investors and the markets generally.

As part of this process, it is imperative that the CFTC consult with the SEC, as the SEC is the primary regulator of registered investment companies. In establishing the CFTC/SEC Joint Advisory Committee,[102] the SEC and CFTC have already put in place the infrastructure to coordinate on addressing matters of joint interest such as addressing the May 6, 2010 "flash crash."[103] The CFTC and SEC are also currently cooperating on issuing joint rulemakings.[104] However, to date we are not aware that the SEC and CFTC are consulting formally on this proposed rulemaking. The issues should be explored with a joint study, which could be spearheaded by the CFTC/SEC Joint Advisory Committee. The two agencies should also

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102 "The committee's objectives and scope of activities shall be to conduct public meetings, to submit reports and recommendations to the CFTC and the SEC and otherwise to serve as a vehicle for discussion and communication on regulatory issues of mutual concern and their effect on the CFTC's and SEC's statutory responsibilities. Subjects to be addressed by the committee shall include…the agencies' efforts on regulatory harmonization. The committee shall work…to recommend processes and procedures for achieving and reporting on those goals." Charter of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues, Objectives and Scope of Activities, *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/cftc-sec-joint_charter.pdf.

103 Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, Findings Regarding the Market Events of May 6, 2010 (Sept. 30, 2010), *available at* http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

104 Under the Dodd-Frank Act, the two Commissions have proposed two joint rulemakings.

consider engaging various industry participants by holding roundtables, as the CFTC did in preparation for the 2003 Amendments.[105]

In engaging in the regulatory process addressing potential changes to Regulation 4.5, the CFTC will also need to keep in mind its duties under the Administrative Procedures Act.[106] A final rule that does not address and reconcile identified conflicts and issues would be not only burdensome and costly for industry participants, but would be unworkable. Compliance as a dual registrant would be impossible under the current regimes. If the CFTC modifies its rule proposal to address these issues, it must provide the public with further opportunity for meaningful comment. Absent this opportunity for industry participation, a final rule that deviates significantly from the proposed rule could be subject to legal challenge. Despite receiving detailed comment letters from the industry on all aspects of the Notice of Petition, the only modification the CFTC made to the proposal between the Notice of Petition and the Proposing Release was to add swaps to both the five percent initial margin test and marketing restriction. The CFTC has not yet provided an analysis of the comments it received on the Notice of Petition, although comments appear to have informed its further questions to the industry. Additionally, the CFTC has not provided a cost-benefit analysis on the proposed rulemaking. As discussed above, it may be unable to provide a meaningful analysis until other regulations are finalized.

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105 2003 Release, 68 Fed. Reg. at 47223. A selection of roundtable participant comments is *available at* http://www.cftc.gov/opa/press02/opa4700-02.htm.

106 5 U.S.C. §§ 551-559.

If the CFTC is determined to proceed to modify the regulatory regime applicable to mutual funds, the rule changes should be reproposed after taking into account additional industry comments in comment letters and other engagements with the public, performing appropriate studies and consulting with the SEC, which is the primary federal regulator of the mutual funds industry.

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Thank you for considering our views on this important topic. If you have any questions or if we can provide any additional information that may assist the CFTC and its Staff, please contact Jack Murphy at 202.261.3303 or jack.murphy@dechert.com, Holland West at 212.698.3527 or holland.west@dechert.com, Brendan Fox at 202.261.3381 or brendan.fox@dechert.com, Stephen Bier at 212.698.3889 or stephen.bier@dechert.com, Julien Bourgeois at 202.261.3451 or julien.bourgeois@dechert.com or Audrey Wagner at 202.261.3365 or audrey.wagner@dechert.com.

Respectfully submitted,

/s/ Dechert LLP

Dechert LLP