April 12, 2011

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

Re: Notice of Proposed Rulemaking, Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance (RIN 3038–AD30)

Dear Mr. Stawick,

The Association of Institutional Investors ("Institutional Investors") is pleased to provide comments to the Commodity Futures Trading Commission ("CFTC" or "Commission") on its proposed rule relating to amendments to compliance obligations for commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") (the "Proposed Rule").[1] Institutional Investors supports the Commission's efforts to effectively regulate the derivatives market and to implement the transparency and oversight goals at the core of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

Institutional Investors is an association of some of the oldest, largest, and most trusted investment advisors in the United States. Our clients are primarily institutional investment entities that serve the interest of individual investors through public and private pension plans, foundations, and registered investment companies. Collectively, our member firms manage pension, 401K, mutual fund, and personal investments on behalf of more than 100 million workers and retirees. Our client's rely on us to prudently manage participants' retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty owed to these individuals. We recognize the significance of this role, and our comments are intended to reflect not just the concerns of Institutional Investors, but also the concerns of the families and individuals we ultimately serve.

I. Summary of Comments

We encourage the CFTC to retain the current exemptions under Sections 4.5, 4.13(a)(3) and 4.13(a)(4). Institutional Investors believes that implementing this Proposed Rule, in its current form, is problematic for investment advisers and registered investment companies for the following reasons:

[1] *See* Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 76 Fed. Reg. 8,068 (February 11, 2011).

- There are several unknown factors yet to be defined by the Commission and other regulators under Dodd-Frank Act implementation efforts, including key definitions for swaps and other terms, margin and collateral requirements, and the regulation of foreign currency products, which will have direct effects on this Proposed Rule.

- The Proposed Rule will subject already highly regulated entities to unnecessary and redundant regulatory requirements.

- The Proposed Rule has the potential to strictly limit investment strategies and impose additional costs on investors, without any corresponding market benefits.

If the Commission proceeds, we suggest that it revise its proposed language to exclude swaps, view risk management transactions as bona-fide hedging transactions, increase the five percent limitation on speculative transactions, and significantly narrow the marketing restriction. The Institutional Investors supports amending the Proposed Rule to ensure that all funds created prior to its effective date be "grandfathered in," permitting such existing funds to continue operating under the current regulatory framework.

Furthermore, we respectfully request that the Commission delay finalizing the Proposed Rule, and re-propose the rulemaking once the Dodd-Frank Act implementation efforts are complete. Such a delay is prudent because it is impossible to appreciate the complete impact of the Proposed Rule until the Commission has addressed the numerous yet-to-be-defined elements that are fundamental to its application, such as certain product definitions and margin requirements.

II. General Concerns

Dodd-Frank Act Rulemakings

Institutional Investors recognizes the Commission's authority under the Commodity Exchange Act ("CEA") to register and regulate CPOs and CTAs.[2] We do not believe, however, that the Dodd-Frank Act necessarily requires the changes brought about by this Proposed Rule and we believe the Proposed Rule should be delayed while the Commission and the industry focuses their efforts on finalizing and implementing the pending regulatory requirements under the Dodd-Frank Act. The Commission's efforts to implement the Dodd-Frank Act are commendable: the agency has thoughtfully and carefully proposed and implemented numerous rulemakings that are explicitly required under the statute. Over the next several months, the Commission's implementation efforts will not cease; there are still many proposed rules required under the Dodd-Frank Act that the Commission has either not yet addressed or not yet fully implemented. Accordingly, the Commission should focus on the required rulemakings and delay implementing or finalizing the Proposed Rule until the Dodd-Frank Act implementation efforts are complete.

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[2] 7 U.S.C. § 1, *et seq.*

Furthermore, several of the Commission's rulemakings required under the Dodd-Frank Act will directly affect this Proposed Rule. Until the Commission issues final rules on these topics, it is difficult for both the Commission and market participants to truly understand the Proposed Rule's impact on registered investment companies ("RICs") and the market in general. Institutional Investors respectfully requests that the Commission draft and implement the rulemakings in a logical order to ensure minimal unnecessary market disruption.

Currently, Institutional Investors cannot adequately evaluate several of the Proposed Rule's provisions due to this regulatory uncertainty. For example, the Treasury Department has yet to determine whether foreign exchange currency products will be subject to additional regulation as "swaps" under the Dodd-Frank Act. These products are important components to the strategies of many RICs and without determining whether they will constitute "swaps," and are therefore covered by the Proposed Rule, it is impossible for industry participants to adequately and accurately assess the impact of the Proposed Rule.

Furthermore, apart from whether or not foreign exchange currency products will be subject to additional regulation, the Commission must promulgate a final definition for the term "swaps" prior to implementing this Proposed Rule. This definition will play a significant role in allowing interested parties such as Institutional Investors to fashion informed responses to this Proposed Rule, because it will determine which products fall under this designation and therefore how RICs will utilize various derivative products.

Other agencies, such as the SEC, are also proposing rulemakings concurrently with the Commission that may affect provisions of this Proposed Rule. Regulatory harmonization is imperative, and it would be far better for the Commission to delay this rulemaking and confer with other agencies to ensure that oversight and regulation across the various agencies are neither duplicative nor inconsistent.

Institutional Investors also requests that the CFTC provide the marketplace with time to adjust to the Commission's new rules and regulations. There are already a significant number of required rulemakings under the Dodd-Frank Act that the industry is struggling to ready itself to implement. It is prudent for the Commission to allow the market time to adjust to these rulemakings before introducing additional changes which may be unnecessary after implementation of the required Dodd-Frank Act rules.

Unnecessary, Duplicative and Conflicting Regulatory Requirements

The Commission's Proposed Rule stems, in part, from a petition filed by the National Futures Association ("NFA") to amend CFTC Regulation 4.5.[3] In the petition, the NFA cited concerns for customer protection as the rational for amending the rule, explaining that three mutual funds were filing for exclusions under Section 4.5 to exempt certain qualified RICs under their control from

[3] *See* Petition for Rulemaking to Amend CFTC Regulation 4.5, National Futures Association, (June 29, 2010), *available at:* http://www.nfa.futures.org/news/newsPetition.asp?ArticleID=2491

CPO registration. Beyond the actions of these three funds, the NFA does not provide any additional facts regarding the possible "abuse" of the Section 4.5 exemptions.

The NFA further justified amending Section 4.5 based on concerns that certain registered CPOs may, in the future, use the current Section 4.5 exemption, thereby offering pools of "*de facto* commodity pool interests" without the burden of regulation as a CPO. However, this is purely speculative, and the NFA provides no evidence of this sort of "migration" occurring in the petition. Further, while these concerns may be valid, without additional review of current market practices in this area there is not sufficient evidence in this petition to warrant the changes it proposes. These are substantial amendments to the rules that the industry relies upon and incorporates into its current operating structure. Institutional Investors respectfully requests the Commission not to require the industry to dispense extensive resources to comply with changes that might not be warranted.

According to the Commission, the rational for this Proposed Rule is to "(1) bring the Commission's CPO and CTA regulatory structure into alignment with the stated purposes of the Dodd-Frank Act; (2) encourage more congruent and consistent regulation of similarly situated entities among Federal financial regulatory agencies; (3) improve accountability and increase transparency of the activities of CPOs, CTAs, and the commodity pools that they operate or advise; and (4) facilitate a collection of data that will assist the FSOC, acting within the scope of its jurisdiction, in the event that the FSOC requests and the Commission provides such data. The proposed amendments will also allow the Commission to more effectively oversee its market participants and manage the risks posed by the commodities and derivatives markets."[4]

The RICs impacted by this Proposed Rule are already subject to robust regulatory requirements and federal oversight. The RICs comply with extensive registration, reporting and disclosure requirements under the Investment Company Act,[5] as well as certain SEC advertising requirements.[6] The SEC anti-fraud provisions of the Securities Act of 1933[7] and the Securities Exchange Act of 1934[8] also provide industry oversight. Furthermore, with respect to private funds that are currently eligible for the Section 4.13(a)(3) and 4.13(a)(4) exemptions, most of the investment advisers to these funds are, or will be, extensively regulated, and comply with the Investment Advisers Act of 1940, which includes additional advertising restrictions and anti-fraud protections.[9]

Furthermore, swaps utilized by RICs will be subject to clearing and extensive reporting requirements imposed by the Commission under the Dodd-Frank Act.[10] Commodity futures and commodity options are already traded on exchanges and subject to reporting requirements. These products will

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[4] *See* Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 76 Fed. Reg. at 7,978.
[5] *See* 15 U.S.C. § 80-1 *et seq.*
[6] *See* 17 C.F.R. § 230.482.
[7] *See* Section 17(a)(3), 15 U.S.C. § 77q(a)(3).
[8] *See* Section 10-b, 17 C.F.R § 240.10b-5.
[9] *See* 15 U.S.C. § 80b-6.
[10] *See* CEA Section 2(h)(1)(A) ("It shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization…").

also be subject to position limits and additional rules imposed by the central clearing organizations, exchanges and swap execution facilities on which these products will be cleared and traded. Given the highly regulated nature of both the entities and products that the Commission is considering to regulate under the amended Section 4.5, it is potentially unnecessary, burdensome, and costly to impose additional regulations.

Institutional Investors respectfully notes that certain requirements found in the Proposed Rule are not only duplicative, but in contradiction with other proposed rules currently under consideration by the SEC. For example, in the Proposed Rule, the Commission requires RICs to provide a boilerplate swaps risk disclosure to shareholders while the SEC is pursuing an initiative that will require a tailored disclosure of a fund's exposure in derivatives. This type of detailed disclosure will provide investors with a better understanding of the funds involvement in derivatives than the boilerplate disclosure requirement found in the Proposed Rule's amendments to the Risk Disclosure Statements under Sections 4.24(b) and 4.34(b). Such competing disclosure requirements will unnecessarily burden RICs and may also mislead and confuse investors.

Substantial Unknown Costs

The Proposed Rule may impose a substantial financial burden on investment companies and investors. This expense will be largely fund based and the costs will be passed through to investors either directly or through fee increases. In the Proposed Rule, the Commission neglects to provide a meaningful cost-benefit analysis. This is inconsistent with President Obama's Executive Order No. 13,563, which requires the Commission to only propose or adopt a regulation upon a reasoned determination that its benefits justify its costs.[11] Merely providing estimates of hours required for compliance with the Proposed Rule does not provide the Commission or market participants with enough information to adequately estimate costs.

Among the known costs associated with the Proposed Rule are: NFA registration and membership fees; testing requirements for the National Commodity Futures Examination (i.e. the Series 3); NFA fitness examinations; and increased reporting obligations. Furthermore, entities may have to re-structure, adjust investment strategies, and fund surveillance to ensure compliance with the Proposed Rule. These costs are all in addition to the financial burdens already imposed on these entities under the SEC regulatory regime.

Many unknown costs may also be associated with this Proposed Rulemaking, making it even more difficult for RICs and investors to adequately estimate the costs associated with the proposed changes. The definition of "swaps" and the related margin and capital requirements for "swaps" are yet unknown, and makes calculation of costs associated with the current proposed language impossible since there is currently no way to know how many funds might hit the five percent threshold.

[11] Exec. Order No. 13,563, 76 Fed. Reg. 3,821 (January 21, 2011).

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III. Specific Provisions

Section 4.5: Exclusion from the Definition of the Term "Commodity Pool Operator"

Section 4.5 of the Proposed Rule requires entities to file a notice of eligibility that contains a representation that the use of commodity futures, commodity options, or swaps for non-hedging purposes be limited to five percent of the liquidation value of the qualifying entity's portfolio.[12] The qualifying entity may not market itself to the public as a commodity pool or vehicle for trading in (or otherwise seeking exposure to), the commodity futures, commodity options, or swaps markets.[13] Section 4.5 requires all entities claiming an exemption to file an annual notice affirming the exemption with the NFA.[14]

The Proposed Rule not only rescinds the exemptions provided in the 2003 amendments,[15] it greatly expands the regulatory requirements under Section 4 of the CEA. With the inclusion of swap transactions, the Proposed Rule greatly expands the types of transactions requiring CPO registration. Since 2003, the market and how it operates has evolved within the parameters set forth in the 2003 rule amendments. The rescission of this exemption introduces a great amount of uncertainty for market participants.

Bona-fide Hedging Exemption

Institutional Investors encourages the Commission to include "risk-mitigating transactions" as bona-fide hedging activities for the purposes of this Proposed Rule. RICs rely on derivative products involving interest rates, bonds, and foreign currency exposures to limit the risks associated with their other portfolio holdings. These transactions are not speculative bets on the market, but rather are legitimate hedging activities that protect investors from unexpected market fluctuations and mitigate losses in times of crisis. It is important that the Commission's final rule preserve these investor protections and permit economic risk-mitigating transactions as bona-fide hedging activity.

Five Percent Limit for Non-Hedging Purposes

Under the Proposed Rule, investment adviser companies that use commodity futures, commodity options and swaps for non-hedging purposes must limit exposure to just five percent of the liquidation value of the entity's portfolio.[16] The five percent limit does not reflect current market practices since the initial margin required for most futures transactions is above five percent and will most likely be above five percent for swaps. Furthermore, it does not appear to Institutional

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[12] *See* Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 76 Fed. Reg. at 7,989.
[13] *See Id.*
[14] *See Id.*
[15] *See Id.* at 7,976.
[16] *See Id.* at 7,989.

Investors that there is any specific compelling justification for reinstating the limit at this level. Institutional Investors believes it would be prudent for the Commission to further examine this issue before setting such a firm, restricted limit.

In addition, it is extremely important to recognize that for most funds there is a substantial difference between a portfolio's exposure to commodity futures and options products and the portfolio's exposure to swaps products. Institutional Investors believes that the limit calculation should be restricted to futures and options products, not swaps. The Dodd-Frank Act already includes substantial regulation for these products, which is further complicated due to the current uncertainty regarding this developing regulatory regime. Until the Commission finalizes the swap regulatory regime and both the Commission and the market has an opportunity to gauge the necessity for further regulation, swaps products should not be included in this calculation.

Marketing Restriction

Institutional Investors is also concerned about the marketing limitations imposed by new Section 4.5 of the Proposed Rule. As currently drafted, the Proposed Rule could require any investment company to register as a CPO if there is any mention of derivatives products in the investment company's marketing materials, even if the investment company only uses derivatives products for bona-fide hedging or if the fund remains below the five percent limit for non bona-fide hedging. Many fixed income funds currently make risk disclosures. The restriction as proposed is expansive, potentially reaching far more of the market than those that routinely use derivatives products for purely speculative purposes.

We believe this marketing restriction is overly broad and goes beyond the language used prior to 2003. RICs currently disclose their investment strategies to investors, including disclosures about how derivatives are used even where the use is not extensive. We believe that this marketing limitation will restrict the ability of RICs to otherwise meet the Commission's requirements for exemption from registration as a CPO. It would arguably run counter to the overall transparency and investor protection goals of the Dodd-Frank Act to inhibit advisers from disclosing their practices for even the occasional use of derivatives products. These products are an important tool in managing the risk of the fund and protecting the investor. Institutional Investors believes that the Proposed Rule may inadvertently encourage less disclosure in marketing materials, or worse, even deter the use of derivatives products by investment advisers out of fear of being designated as a CPO.

Institutional Investors recommends that the Commission approach the newly proposed section 4.5 standard through a two-step process. Step one would be to determine whether the investment company qualifies for the exemption under the bona-fide hedging (including risk management use such as duration trades) or five percent limit exemptions. Step two would be to apply the marketing restriction to investment companies that do not qualify for the bona-fide hedging or five percent limit exemptions.

Institutional Investors also believes that the Commission should clarify the marketing restriction. The Proposed Rule is unclear as to what activities constitute "marketing," and thus what activities may subject entities to the CPO registration requirements. Furthermore, Institutional Investors requests clarification that the Proposed Rule's marketing restrictions do not apply to basic prospectus disclosures.

We respectfully request the proposed new language also be limited to clarify that it is not applicable to registered investment companies with only a minimal exposure to futures and options products. Further, we urge the Commission to delete the "*or otherwise seeking investment exposure*" language since it is unclear what this language is meant to address.[17] We are concerned that this language would cause "fund-of-funds" structures to hit the marketing restrictions due to even minor investments in underlying funds that use commodity futures, commodity options, and swaps. Without clarification, this language may also restrict a fund investing in unaffiliated Exchange Traded Funds ("ETF") that in turn invest in these products as well. Additional regulation for these entities is not necessary: the subsidiary arrangements are operated in accordance with IRS "no-action letters" following SEC guidelines set forth in the Investment Companies Act of 1940.

Section 4.13: Exemption from Registration as a Commodity Pool Operator

The Commission proposes to rescind certain exemptions from registration provided in sections 4.13(a)(3) and (a)(4). Under the current regulations, a person is exempt from registration as a CPO if the interests in the pool are exempt from registration under the Securities Act of 1933 and offered only to qualified eligible persons ("QEPs"), accredited investors, or knowledgeable employees, and the pool's aggregate initial margin and premiums attributable to commodity interests do not exceed five percent of the liquidation value of the pool's portfolio. The Proposed Rule will eliminate the exemptions under Sections 4.13(a)(3) and (a)(4) for operators of pools that are similarly situated to private funds that previously relied on the exemptions under the Investment Company Act and the Investment Advisers Act.[18]

Institutional Investors is concerned that similar to the proposed changes to Section 4.5, removing the 4.13 provisions will introduce substantial additional compliance requirements on investment advisers, most of which are or will be, due to the changes introduced by the Dodd-Frank Act, registered with the SEC and would already comply with significant SEC regulation requirements. Furthermore, removing these exemptions might cause investment advisers to be required to register as CTAs with the Commission. These unnecessary additional compliance burdens will lead to substantial increased costs for the industry in an attempt to address an undefined problem with little or not benefit to the market or investors.

If the Commission moves forward with the recession of Section 4.13(a)(4), Institutional Investors proposes that Section 4.13(a)(4) remain available for wholly owned subsidiaries or RICs as long as the books and records of such subsidiaries are made available to the Commission upon request and

[17] *See Id.*
[18] *See Id.* at 7,985-6.

certain other requirements are met (e.g. the subsidiary is subject to the 1940 Act leverage requirements and the fees and holdings of the subsidiary are disclosed to the RIC's shareholders).

Data Collection and Annual Filing of Exemptions

Section 4.27 of the Proposed Rule requires additional new reporting requirements for CPOs and CTAs through the use of proposed forms CPO-PQR and CTA-PR. As acknowledged by the Commission in the preamble to the Proposed Rule, the required Forms CPO–PQR and CTA–PR solicit information that is generally identical to that sought through Form PF, a new form contemplated by another proposed rule being jointly promulgated by the Commission with the SEC.[19] These forms bring with them new quarterly and annual filing requirements, in addition to the reporting requirements already mandated by the SEC.

It appears that certain investment advisers to private funds who will likely be required to file Form PF will also be required to file either Form CPO-PQR or Form CTA-PR, depending on trading activity. This requirement creates unnecessary, duplicative and burdensome filing requirements for the industry with no additional benefit to the regulators, investors, or the market. While there is some evidence in the Proposed Rule that the Commission will not require this duplicative filing requirement, Institutional Investors urges the Commission to provide further clarification on this matter and eliminate any unnecessary or duplicative disclosure requirements. Institutional Investors believes that Form PF is an appropriate outlet for all necessary disclosure.

In addition, Institutional Investors requests additional clarification regarding the Commission's quantification methods for assets under management regarding determinations of the appropriate form and frequency of filing. In particular, it is unclear whether the "total assets under management" encompasses all of the assets managed by a CPO or a CTA, or only commodity pool assets. Institutional Investors recommends this measure include only commodity pool assets to better reflect the actual exposure of commodities in managed assets.

In evaluating the size of a CPO to determine the applicable reporting requirements, Institutional Investors suggests that the Commission utilize two sets of metrics: (1) the amount of commodity pool assets under management; and (2) the volume of market activity engaged in by the entity. Relying solely on the size of the fund may allow smaller entities that engage in heavy trading activity to escape regulatory oversight, even though these entities may have a substantial impact on the market.

Institutional Investors is also concerned about the burdens associated with the annual renewal of the exemption filings for entities that remain under the CPO/CTA exemptions. With respect to the renewal of CPO exemption filings, it would be helpful for the Commission to clarify whether a CPO must initiate an individual filing for each fund operating under the exemption, or whether a single check-the-box filing can be done encompassing all the applicable funds under operation. If the

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[19] *See Id.* at 7,978.

Commission determines that an individual filing is necessary for each fund operating under the exemption, Institutional Investors respectfully requests the Commission to examine alternative filing arrangements to lessen this burden. The annual renewal of exemptions should also be based on a calendar year-end instead of annually on the date of the initial filing.

"Grandfather-in" Provision

Institutional Investors encourages the Commission to amend the Proposed Rule to allow for funds created prior to its effective date to be "grandfathered-in." Investors and their advisers tailored these funds to operate in a manner consistent with the post-2003 regulatory regime, and should be permitted to continue operating under the current regulatory framework. Requiring the substantial restructuring of these funds is unwarranted and will lead to additional costs for investors.

Conclusion

Institutional Investors believes that this Proposed Rule has the potential to subject already highly regulated entities to overly burdensome regulatory requirements. Further, without clarification, certain provisions within the Proposed Rule may unintentionally limit investment strategies and impose unnecessary costs on investors. Institutional Investors respectfully requests the Commission to delay finalizing the Proposed Rule and to re-propose the rulemaking once the Dodd-Frank Act implementation efforts are complete.

Institutional Investors would like to thank the Commission for the opportunity to comment on the Proposed Rule. Please feel free to contact the undersigned with any questions you may have on our comments.

Very truly yours,

John Gidman, on behalf of
Institutional Investors