

July 28, 2011

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

Re: Follow-up to July 6, 2011 Roundtable on CFTC Proposal to Amend Rule 4.5 and Rescind Rules 4.13(a)(3) and 4.13(a)(4) (RIN No. 3038-AD30)

Dear Mr. Stawick:

We appreciated the opportunity to participate in the staff's recent roundtable regarding the proposal by the Commodity Futures Trading Commission ("Commission" or "CFTC") to amend Rule 4.5 under the Commodity Exchange Act and rescind Rules 4.13(a)(3) and 4.13(a)(4) under the Act. ICI is submitting this letter to provide additional information and clarification on several specific issues that were discussed at the roundtable.<sup>1</sup> Specifically, we address:

- The use by some registered investment companies of wholly owned subsidiaries to invest in commodity interests;
- How the Commission could collect and use data in connection with amending Rule 4.5;
- How licensing and examination requirements would apply if an investment adviser were required to register as a commodity pool operator ("CPO");
- Why the scope of the definition of *bona fide* hedging under Rule 4.5 is not broad enough to encompass transactions in commodity interests investment company advisers engage in to further the management of their securities portfolios; and
- Additional points on our requests for relief from the books and records and past performance requirements under the Commodity Exchange Act rules.

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.3 trillion and serve over 90 million shareholders.

## **Use of Wholly Owned Subsidiary Structure**

Many registered investment companies that invest in commodity interests do so pursuant to approximately 70 Internal Revenue Service (“IRS”) private letter rulings (“PLRs”). Those PLRs issued to registered investment companies that use wholly owned subsidiaries to invest in commodity interests explicitly approve this structure for tax purposes.<sup>2</sup> As explained in more detail in our April comment letter (“April 12 Letter”),<sup>3</sup> registered investment companies use these subsidiaries in order to satisfy one of the requirements of Subchapter M of the Internal Revenue Code, which provides for quasi-pass-through tax treatment of registered investment companies’ income.<sup>4</sup> Specifically, Subchapter M requires that each registered investment company must realize at least 90 percent of its annual gross income from specified investment-related sources. This income is referred to as “qualifying” income.

### **A. Which Investments Must Be Made Through a Subsidiary?**

The Internal Revenue Code references the Investment Company Act of 1940 (“Investment Company Act”) as the starting point for determining whether an investment generates qualifying income for purposes of Subchapter M.

- If an investment is a security as defined under the Investment Company Act, it generates qualifying income (for example, a commodity-linked note).
- For investments such as futures, options, and swaps that are *not* Investment Company Act securities, tax law looks to the reference asset to determine whether the investment generates qualifying income. Thus, if the reference asset is a physical commodity or an index of physical commodities, the investment does not generate qualifying income, unless the investment company invests in these instruments *through* a security. Shares of a wholly owned subsidiary

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<sup>2</sup> Some of the 70-plus PLRs have been issued to registered investment companies that invest in notes that pay interest by reference to a commodity index (“commodity-linked notes”). Because of the severe consequences of failing to satisfy the requirements of Subchapter M of the Internal Revenue Code of 1986, as amended (“Internal Revenue Code”), registered investment companies have sought rulings on this structure to eliminate any uncertainty regarding the treatment of these notes as securities.

<sup>3</sup> Letter from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, CFTC, dated April 12, 2011, available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42191&SearchText>.

<sup>4</sup> Registered investment companies generally are referred to as “quasi-pass-through” vehicles for tax purposes because the character of the income that investment companies receive is retained, when paid to shareholders, only to the extent provided by Subchapter M. For example, while gains on securities held by an investment company for more than one year are taxable to shareholders when distributed as capital gain dividends (treated as long-term capital gains), gains on securities held by investment companies for shorter periods are taxable to investors when received as ordinary dividends (rather than as short-term capital gains). Moreover, an investment company’s losses do not pass through to investors, as they would in a “pass-through” vehicle (such as a partnership).

are securities and, as discussed above, the use of such subsidiaries has been expressly permitted by IRS PLRs as a means to generate qualifying income. If the reference asset itself is a security or an index of securities, however, the income generated is qualifying income and the investment (*e.g.*, a swap on the S&P 500) need not be made through a wholly owned subsidiary.

B. Is the Subsidiary Subject to Regulation?

As fully disclosed in the PLRs, the wholly owned subsidiaries are established offshore to protect registered investment company shareholders from an additional level of taxation. While the subsidiary is established offshore, it remains subject to regulation under U.S. law. This is primarily a function of the conditions of relief under the PLRs, representations made to the Securities and Exchange Commission (“SEC”) staff, and application of the Investment Company Act’s principle that a registered investment company cannot do indirectly what it is prohibited from doing directly (see discussion below).

- The PLRs require the subsidiary to comply with Section 18 of the Investment Company Act and all associated guidance from the SEC regarding coverage and the use of leverage by registered investment companies.<sup>5</sup>
- Under Subchapter M, a registered investment company may invest no more than 25% of its total assets in the subsidiary.
- Under the PLRs, the subsidiary is established offshore as a limited liability corporation, thus limiting the liability of its shareholder (the investment company).
- It is our understanding that the staff of the SEC’s Division of Investment Management requires registered investment companies employing a subsidiary structure to operate the subsidiary in conformity with the key substantive provisions of the Investment Company Act, notably Section 8 (investment policies), Section 17 (affiliated transactions and custody requirements) and Section 18 (capital structure and leverage).
- The Investment Company Act prohibits a registered investment company from using a subsidiary to engage in any activity that the investment company could not engage in directly under the Investment Company Act.<sup>6</sup>

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<sup>5</sup> Under Section 18 of the Investment Company Act, a registered investment company is limited in its ability to issue “senior securities,” a term that is interpreted by the SEC and its staff to potentially include engaging in certain derivatives transactions. The SEC and its staff have stated that a registered investment company may, however, engage in such derivatives transactions, if it “covers” its obligations by segregating assets in an amount sufficient to satisfy its obligations under the instruments or by entering into transactions that offset its obligations.

<sup>6</sup> See Section 48(a) of the Investment Company Act, which prohibits any person from doing, or causing to be done through another person, anything that would be unlawful for that person to do directly under the Investment Company Act or the rules under that Act.

Thus, as the above discussion makes clear, this subsidiary structure is used by registered investment companies for legitimate tax purposes and not to evade regulation. In addition, as we discuss further below, we acknowledge that the CFTC and National Futures Association (“NFA”) have an interest in being able to examine the subsidiary’s books and records as part of their oversight responsibilities.

C. Does the Investment Company Disclose the Subsidiary’s Holdings and Fees?

Registered investment companies disclose to investors the investment activities and holdings of any wholly owned subsidiary.<sup>7</sup>

- Disclosure in the investment company’s prospectus and statement of additional information must describe the company’s investment objective, the principal investment strategies, including the types of securities in which the investment company may invest, and the risks associated with that investment strategy.<sup>8</sup>
- The investment company must provide shareholder reports to its investors and those reports must contain audited financial statements identifying the company’s investments.<sup>9</sup> The financial statements of the wholly owned subsidiary may be consolidated into the investment company’s financial statements, in which case the subsidiary’s investments are disclosed as if the investment company held them directly. Alternatively, the wholly owned subsidiary itself may be presented as an investment in the investment company’s schedule of investments, in which case the wholly owned subsidiary’s financial statements would be included in the company’s shareholder report, so that an investor in the registered investment company could see the investments held by the subsidiary.

We understand that most investment companies with wholly owned subsidiaries currently reflect any fees of the subsidiary in the investment company’s prospectus fee table and expense ratio. This appears not to be the case, however, for a small minority of investment companies that utilize separate CTAs to invest in commodity interests.<sup>10</sup> We strongly endorse transparency of fees for *all*

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<sup>7</sup> We also note that registered investment companies, whether they invest directly or through wholly owned subsidiaries, are subject to CFTC large trader reporting requirements like any other trader. *See* Parts 15-19 and 21 of the CFTC’s regulations. These requirements enable the CFTC to obtain trading information from those entities that it can use to assess systemic risk.

<sup>8</sup> *See* Items 4 and 9 of Form N-1A under the Investment Company Act.

<sup>9</sup> *See* Item 27 of Form N-1A under the Investment Company Act.

<sup>10</sup> We understand that most investment companies that use wholly owned subsidiaries to invest in commodity interests invest in those interests directly through the subsidiary, and the adviser to the investment company also manages the assets of the subsidiary. In contrast, a small minority of these investment companies utilize commodity trading advisors (“CTAs”) to manage the assets of the wholly owned subsidiary. The CTAs may invest the subsidiary’s assets through accounts established for that purpose, or the subsidiary may invest in commodity pools or private investment vehicles. We understand

investment companies that invest in commodity interests, regardless of structure. We therefore would support the CFTC requiring, as a condition to relying on Rule 4.5, that an investment company disclose any fees deducted from the assets of its wholly owned subsidiary in the investment company's prospectus fee table and expense ratio.<sup>11</sup>

In our April 12 Letter, we suggested that the Commission also could condition the Rule 4.5 exclusion on the CFTC and NFA having access to the subsidiary's books and records. Access to these books and records would provide the CFTC and NFA with the ability to review trading activity within the subsidiaries. We note that the NFA, in its April 12, 2011 comment letter to the Commission, stated that it now recommends that the Commission consider permitting investment companies that rely on amended Rule 4.5 to use wholly owned subsidiaries, provided the subsidiary's books and records are subject to inspection by the CFTC and NFA.<sup>12</sup>

D. Should the IRS' Reexamination of Private Letter Rulings Affect the CFTC's Consideration of Rule 4.5?

We understand that the IRS has suspended issuing PLRs to registered investment companies that invest in commodity-related interests while it reexamines the analysis in those rulings. Registered investment companies have adopted the wholly owned subsidiary structure, as we discuss above, solely to comply with Subchapter M of the Internal Revenue Code. Because of the tax implications for the investment company and its shareholders, this structure is essential.

The IRS' reexamination of its positions should not implicate the CFTC's consideration of the ability of investment companies, including those that invest through wholly owned subsidiaries, to rely on Rule 4.5. The agencies have different interests, which can be separately addressed. The CFTC's interest in the subsidiaries primarily appears to be adequate regulatory oversight, disclosure to investors of fees and expenses, and being able to monitor trading in the commodity markets, all matters that are already, or can be readily, addressed. As we have explained, a registered investment company's use of a wholly owned subsidiary to invest in commodity interests should not preclude it from relying on proposed Rule 4.5. The subsidiary is subject already to significant controls on its operations. In addition, the Commission could require, as conditions to relying on Rule 4.5, disclosure of fees and

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that some of these investment companies do, however, include information about the fees and expenses associated with the wholly-owned subsidiary's investments with the CTAs, or in the commodity pools or private investment vehicles in footnotes to the investment company's fee table including, in some cases, an estimated range of performance fees.

<sup>11</sup> The SEC or CFTC would need to provide guidance as to the treatment of performance fees, if any, paid to any CTAs managing assets of the wholly owned subsidiary.

<sup>12</sup> Letter from Thomas W. Sexton, III, Senior Vice President and General Counsel, NFA, to David A. Stawick, Secretary, CFTC, dated April 12, 2011, *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42160&SearchText>.

expenses deducted from the subsidiary's assets, and Commission and NFA access to the subsidiary's books and records. We believe there is no reason that the IRS' current reexamination of the PLRs should preclude the Commission from permitting investment companies with wholly owned subsidiaries to rely on amended Rule 4.5.

The IRS' decision to suspend the PLR process raises another serious concern for the industry. Specifically, this suspension has already caused competitive imbalances within the industry that will only increase the longer the rulings process is halted. If the issues that the CFTC is considering under proposed Rule 4.5 and those that the IRS is considering under the tax laws are unrelated, as we believe, there is no reason for the IRS to suspend rulings merely because the CFTC is considering amending Rule 4.5. If you agree, we would appreciate your assistance in confirming this view with the IRS. We already have asked the IRS to move quickly and restart the PLR process promptly.

E. What is the Regulatory Status of the Subsidiary?

Another topic that was mentioned at the roundtable was the regulatory status of the wholly owned subsidiary. We understand that some advisers to registered investment companies that invest in commodity interests through wholly owned subsidiaries have, out of an abundance of caution, filed exemptions for the subsidiaries under Rule 4.13(a)(4) under the Commodity Exchange Act. If Rule 4.5 is amended and Rule 4.13(a)(4) is rescinded, we believe the Commission should take a holistic approach in considering which entity or entities would become subject to CPO registration.

It seems clear that, if the registered investment company and its wholly owned subsidiary (on a consolidated basis) could satisfy the amended Rule 4.5 criteria, the investment company's adviser would be excluded from CPO regulation. It would make no sense for there then to be a separate registration obligation relating to the subsidiary – the subsidiary is established by the investment company's adviser, whose sole investor is the investment company. No purpose would be served by the subsidiary preparing a separate disclosure document to provide solely to the investment company's board of directors. Alternatively, if the registered investment company could not satisfy the amended Rule 4.5 criteria, the adviser would have to register as a CPO and the CPO requirements should be applied to the consolidated entity, not separately.

This holistic approach is fully consistent with the CFTC's current treatment of analogous investment structures. For example, with respect to master-feeder structures, if only the feeders can invest in the master fund, a disclosure document is only required to be prepared for the feeder funds and that disclosure document includes information about the master fund.<sup>13</sup> Similarly, if an investment pool uses one or more special purpose vehicles ("SPVs") to hold particular investments, no separate disclosure document is required for an SPV if an investor can only participate in the SPV through an

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<sup>13</sup> See Rule 4.21(a)(2) under the Commodity Exchange Act.

investment in the pool.<sup>14</sup> It would therefore elevate form over substance to treat a wholly-owned subsidiary of a registered investment company as a separate pool, if an investor can only invest in the subsidiary through the investment company.

### **Collection of Data**

Several participants at the roundtable suggested that the Commission obtain data from industry participants as a means of better assessing how investment companies invest in commodity interests so that the Commission can determine the appropriate scope of amended Rule 4.5. We agree that this would be a valuable step and would help ensure that any registration requirements and related exclusions are appropriate. We also believe that such data are necessary for the Commission to be able to undertake the careful cost-benefit analysis required by the Administrative Procedure Act. The Commission staff also acknowledged the importance of data in the rulemaking process. We believe that relevant data could be collected in one of two ways:<sup>15</sup>

- The Commission could issue a “special call” for information about entities relying on the current exclusion.<sup>16</sup> ICI would be pleased to assist the Commission’s efforts by strongly encouraging our members to respond promptly to such an information request. We believe that other trade organizations would be equally willing to lend their assistance to such an effort.
- Alternatively, the Commission could amend Rule 4.5 to require entities relying on the rule to provide data that the Commission could then use to determine whether any further changes to the rule are necessary.

We would fully support either of these approaches. Obtaining data from entities relying on Rule 4.5 would help the Commission tailor any amended rule very specifically to the conduct it seeks to regulate. We agree with the point made at the roundtable that, while data collection takes a certain amount of resources, it would take far more resources to regulate on an ongoing basis a large number of registrants that do not raise the Commission’s regulatory concerns.

Regardless of which approach is chosen, we believe that the Commission’s purpose could be accomplished through the collection of a limited amount of data. In our view, the key items could be:

- Basic identifying information for the registered investment adviser;

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<sup>14</sup> *Id.*

<sup>15</sup> The Commission also may obtain trading information from certain registered investment companies pursuant to its large trader reporting requirements. *See supra* note 7.

<sup>16</sup> For example, Rule 4.5 provides that an entity relying on the exclusion “[w]ill submit to such special calls as the Commission may make to require the qualifying entity to demonstrate compliance with the provisions of this §4.5(c) . . .” Rule 4.5(c)(2)(ii).

- The name of the registered investment company, including each relevant portfolio or series within the investment company that is relying on current Rule 4.5;
- For each such portfolio:<sup>17</sup>
  - Confirmation of the portfolio's continued eligibility to rely on current Rule 4.5;<sup>18</sup>
  - In which categor(ies) of commodity instruments the portfolio invests more than a minimum percentage of its assets (*e.g.* futures, commodity options, if swaps are included, different types of swaps) and the range of investment in such instruments as of a specified date;<sup>19</sup>
  - The portfolio's most recent financial statements filed on Form N-CSR, and the portfolio's most recent schedule of investments filed on Form N-Q.<sup>20</sup>

### **Registration and Licensing**

There was discussion at the roundtable regarding which entity should register as a CPO when the Rule 4.5 exclusion is not available, and what licensing requirements would be applicable. As discussed in detail in our April 12 Letter, we believe the adviser to a registered investment company is the appropriate entity to serve as CPO, as the adviser is the primary force in establishing and operating the company.

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<sup>17</sup> For investment companies that invest in commodity interests through wholly owned subsidiaries, this information would also reflect, or include, information about the wholly owned subsidiary's investment activities.

<sup>18</sup> See proposed Rule 4.5(c)(5). We agree with the NFA's recommendations in its April 12 comment letter that the Commission should: (i) change the due date of the notice confirmation from an annual requirement based on the exclusion's original filing date to a calendar year due date for all filers; and (ii) provide a 60 day rather than a 30 day period in which an entity relying on the exclusion must affirm. See Letter from Thomas W. Sexton, III, Senior Vice President and General Counsel, NFA, to David A. Stawick, Secretary, CFTC, dated April 12, 2011, *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42160&SearchText>.

<sup>19</sup> The question should specify how this minimum percentage of assets would be calculated – for example, initial margin and premiums required to establish the position or notional value.

<sup>20</sup> Registered investment companies must file with the SEC semi-annual financial statements covering the first six months of their fiscal year and audited annual financial statements covering the twelve month period on Form N-CSR. These financial statements include a schedule of investments identifying all securities and open derivatives contracts held at period end, a balance sheet, an income statement, and a statement of changes in net assets prepared in accordance with generally accepted accounting principles. See Item 27 of Form N-1A and Rule 3-18 of Regulation S-X. In addition, registered investment companies must also file with the SEC a schedule of investments identifying all securities and open derivatives contracts held at the end of the company's first and third fiscal quarters. See Rule 30b1-5 under the Investment Company Act. Form N-Q must be filed with the SEC not more than 60 days after period end. Shareholder reports containing financial statements must be transmitted to shareholders not more than 60 days after period end, and these shareholder reports must be filed with the SEC on Form N-CSR not more than 10 days after they are first transmitted to shareholders.



A. What Information Would an Adviser Registering as a CPO Submit?

The CPO registration process would provide the CFTC with additional information about the adviser, its principals, and any associated person(s).

- An adviser registering as a CPO would include Form 8-Rs for its natural person principals and associated persons, including those investment company directors who are principals and/or associated persons of the adviser.<sup>21</sup>
- The adviser also would submit, on behalf of those persons, a fingerprint card.

B. Who Would Serve as Associated Person of the CPO and Satisfy the Licensing Requirement?

One of the adviser's executive officers would serve as the associated person of the CPO. We believe it would be appropriate for an adviser CPO to have only one associated person for purposes of its CPO registration because the adviser cannot solicit investors for the registered investment company.<sup>22</sup> Instead, that function must be performed by a broker-dealer and is generally performed by registered representatives of the registered investment company's principal underwriter.

Rule 3.12(a) under the Commodity Exchange Act generally provides that it is unlawful for a person to be associated with a CPO as an associated person unless that person is registered as such, which typically requires passing the Series 3 examination. Rule 3.12(h)(1)(ii), however, provides that, if the pool is offered by registered representatives that are associated with broker-dealers registered with the National Association of Securities Dealers (now the Financial Industry Regulatory Authority), the registered representatives are exempt from registration as associated persons as long as they do not engage in other activities subject to regulation by the Commission. As a result, the registered representatives are not required to satisfy the Series 3 licensing requirement.<sup>23</sup> The registered representatives of the investment company's principal underwriter would rely on this exemption to sell the investment company's shares.

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<sup>21</sup> We note that, under the Investment Company Act, all of the investment company's directors, including the independent directors, are subject to statutory disqualification provisions, which are similar to those under the Commodity Exchange Act. *See* Section 9 of the Investment Company Act.

<sup>22</sup> Rule 1.3(aa)(3) under the Commodity Exchange Act defines an associated person of a CPO 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 participation in a commodity pool or (ii) the supervision of persons so engaged." Because the adviser's personnel, in their capacities as such, cannot solicit investors to invest in the fund, the adviser will not have any personnel falling within the associated person definition.

<sup>23</sup> These registered representatives generally would hold Series 7 or Series 63 licenses.

Because it is the registered investment company's principal underwriter, and not its adviser, that offers and sells the investment company's shares, we believe it would be appropriate for the associated person of the investment adviser CPO to satisfy his or her licensing requirement by passing the Series 31 examination rather than the Series 3 examination, and plan to request such relief from the NFA.<sup>24</sup> This recommendation is consistent with the NFA staff's recognition at the roundtable that the Series 3 examination may not be appropriate in this context and their statement that the NFA would not want to require a test that serves no public policy objective.

### **Scope of *Bona Fide* Hedging Exemption**

We believe that the exemption for "*bona fide* hedging" under proposed Rule 4.5 is too narrow to encompass the variety of non-speculative trading strategies that an investment adviser may employ to further an investment company's securities investment objectives. We therefore requested, in our April 12 Letter, that the Commission recognize specifically that certain transactions or positions taken by a registered investment company in futures contracts, options contracts, or swaps should not be subject to the proposed five percent restriction on positions not for *bona fide* hedging purposes (the "Non-Hedging Restriction"). The Commission has acknowledged that hedging clearly encompasses transactions and positions that (i) are temporary substitutes for "cash market" positions; or (ii) mitigate or offset changes in the value of "cash market" positions owned by the investment company or non-derivative liabilities of the investment company.<sup>25</sup> Beyond that, we specifically recommend that the following categories of transactions or positions also be excluded from the Non-Hedging Restriction if used for the following purposes:

- To facilitate the investment company's management of its cash and/or reserves (to the extent such transactions do not already qualify as hedges under the anticipatory hedging or balance sheet hedging categories);
- To adjust the duration of an investment company's portfolio of assets;
- To efficiently adjust a fund's exposure to one or more asset allocation categories; or
- As alternatives to "cash market" positions.

#### A. Why Isn't the Current Definition of *Bona Fide* Hedging Broad Enough to Encompass These Types of Transactions?

The definition of *bona fide* hedging that is relevant for purposes of proposed Rule 4.5 is Rule 1.3(z) under the Commodity Exchange Act, which states, in relevant part, that:

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<sup>24</sup> We believe the more targeted Series 31 examination is better tailored to the associated person's limited activities in this regard than the Series 3 examination, which covers general commodity-related topics.

<sup>25</sup> See *Risk Management Exemptions From Speculative Position Limits Approved Under Commission Regulation 1.61*, 52 Fed. Reg. 34633 (Sept. 14, 1987) (agency interpretation providing for risk-management exemptions, in addition to current exemptions for hedging, from speculative position limit rules of exchanges) ("1987 Interpretation").

Bona fide hedging transactions and positions shall mean transactions or positions in a contract for future delivery on any contract market, or in a commodity option, where such transactions or positions normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel, and where they are economically appropriate to the *reduction of risks* in the conduct and management of a commercial enterprise . . . (emphasis added).

As the Commission discussed in a 1987 agency interpretation (“1987 Interpretation”),<sup>26</sup> financial institutions may engage in a variety of trading strategies involving futures and options (and, today, swaps) that may be characterized as a form of risk management “since each serves to alter an institution’s risk-return profile within the context of the institution’s overall investment objectives and predetermined risk parameters.” The Commission acknowledged that, while some of these strategies involve risk reduction, and therefore fall within the Commission’s *bona fide* hedging definition, others do not involve a reduction in an institution’s risk exposure. The 1987 Interpretation includes the example of how a risk-management exemption concept would apply to a strategy of using futures to extend the duration of a financial institution’s investment portfolio, by using cash to purchase long bond futures contracts. If the strategy is undertaken neither as a “balance-sheet” hedge nor as an anticipatory hedge, thus resulting in a net extension of the duration of the investment portfolio, the Commission states that the long bond futures position could be eligible for a risk-management exemption.<sup>27</sup>

B. Why Should Risk Management Positions be Excluded From the Non-Hedging Restriction?

The 1987 Interpretation reflects an explicit recognition by the Commission that positions taken for risk management purposes do not raise the same concerns as speculative positions, and should be treated differently. The 1987 Interpretation was issued in response to recommendations of Congress, in connection with the Futures Trading Act of 1986, and recommendations of the Commission’s Financial Products Advisory Committee (“FPAC”), that the Commission consider a concept of “risk management” by portfolio managers that would be broader than risk reduction. In the report issued by the FPAC, the FPAC recommended that “[w]here entities are otherwise regulated as

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<sup>26</sup> See *id.*; see also Report of the Financial Products Advisory Committee of the Commodity Futures Trading Commission, *The Hedging Definition and the Use of Financial Futures and Options: Problems and Recommendations for Reform* (June 15, 1987) (“Committee Report”) (Committee’s recommendations included, among others, revising Rule 1.61 and issuing guidelines that permit exchanges to exempt from speculative position limits transactions or positions taken for risk-management purposes, revising Rule 1.3 to include a definition of risk management, and revising Rule 4.5 to provide an exclusion from CPO regulation for otherwise-regulated entities that use futures and options for risk-management purposes).

<sup>27</sup> 1987 Interpretation, *supra* note 25. We note that the 1987 Interpretation provides several other examples of strategies that would be eligible under a risk management approach, and includes analysis of which portions of the strategies would be eligible for exemption as a hedge and which would not.

defined in CFTC Rule 4.5, the exclusion from CPO regulation should be extended to include risk-management activities. Requiring CPO regulation under such circumstances would duplicate other satisfactory registration and oversight requirements, and is unnecessary since the risk-management transactions contemplated are not speculative and are intended to facilitate the entities' investment functions."<sup>28</sup> In recommending that risk management transactions be exempt from speculative limit positions, the FPAC made the following points, which are equally applicable in the context of Rule 4.5:

- In some cases, financial futures and options are used as surrogates for cash-market positions in order to alter risk exposure rather than reduce risk. In other cases, financial futures and options are used to create synthetic positions that complement and complete the array of available investment opportunities. These uses, while not necessarily risk-reducing, allow portfolio managers to effect prudent and non-speculative risk-management strategies in a low cost, flexible, and timely fashion by taking advantage of the transactional efficiencies provided by the futures and options markets.
- These strategies are no more conducive to market manipulation or disruption than currently recognized hedging strategies. The imposition of speculative position limits on such positions unnecessarily limits an important economic contribution of the financial futures and option markets -- the provision of cost efficient transaction services. Those transactions or positions in futures and options that are used for non-speculative risk-management purposes (*i.e.*, as unleveraged surrogates for cash-market transactions or positions or as synthetic positions) should be eligible for exemption from speculative position limits.<sup>29</sup>

### **Areas Requiring Relief**

In our April 12 Letter, we discussed a number of areas in which CFTC and SEC requirements are duplicative or conflict, and the implications for registered investment companies that would be unable to rely on amended Rule 4.5. We provided detailed recommendations for addressing these concerns including, in some instances, suggesting that the CFTC provide relief analogous to that it has provided for commodity exchange-traded funds ("commodity ETFs"),<sup>30</sup> provided that the relief is tailored to reflect the different manner in which registered investment companies operate. Below we address several specific areas that were discussed at the roundtable.

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<sup>28</sup> Committee Report, *supra* note 26.

<sup>29</sup> *Id.*

<sup>30</sup> *Commodity Pool Operators: Relief From Compliance With Certain Disclosure, Reporting and Recordkeeping Requirements for Registered CPOs of Commodity Pools Listed for Trading on a National Securities Exchange; CPO Registration Exemption for Certain Independent Directors or Trustees of These Commodity Pools*, 76 FR 28641 (May 18, 2011) ("Commodity ETF Release").

A. Books and Records

Participants at the roundtable discussed the different recordkeeping requirements applicable to registrants pursuant to the rules under the Commodity Exchange Act and the Investment Company Act, and how these requirements might be reconciled. We discussed in detail in our April 12 Letter the recordkeeping requirements under the Investment Company Act, and requested relief from Rule 4.23 under the Commodity Exchange Act to permit a registered investment company's CPO to maintain its books and records required by the Commodity Exchange Act with professional service providers as permitted by rules under the Investment Company Act.<sup>31</sup> The relief we requested is similar to the relief the Commission granted recently to commodity ETFs.<sup>32</sup> We wish to make the following additional points, based on the discussion at the roundtable.

1. How Would the CFTC or NFA Know Where the Records Are?

An NFA representative stated that, in order to conduct examinations quickly, what is most important is knowing the location of a registrant's books and records. The Investment Company Act and the Investment Advisers Act of 1940 ("Investment Advisers Act") require that this information be disclosed publicly. Specifically, a registered investment adviser is required to specify on its Form ADV each entity that maintains the adviser's required books and records, including the location of the entity, and a description of the books and records maintained at that location.<sup>33</sup> Similarly, a registered investment company is required to disclose in its registration statement the name and address of each person that maintains the investment company's required books and records.<sup>34</sup> An investment adviser CPO or registered investment company that is a qualifying entity, for purposes of Rule 4.5, could represent to the CFTC that this disclosure would include any third party service providers that maintain books and records required under Rule 4.23.

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<sup>31</sup> In brief, under the Investment Company Act rules, a registered investment company may have a third party maintain its books and records on its behalf, if the investment company and the third party enter into a written agreement specifying that the records are the property of the registered investment company and stating that such records will be surrendered promptly upon request. See Rule 31a-3 under the Investment Company Act.

<sup>32</sup> Commodity ETF Release, *supra* note 30.

<sup>33</sup> See Item 1(K) of Part 1A of Form ADV and Section 1.K. of Schedule D of Form ADV.

<sup>34</sup> See Item 33 of Form N-1A (registration statement for open-end registered investment companies); Item 32 of Form N-2 (registration statement for closed-end funds).

2. Could Advisory 18-96 Provide a Roadmap for Relief?

We also wanted to address briefly the potential applicability of Advisory 18-96 (the “Advisory”), which the staff mentioned at the roundtable.<sup>35</sup> The Advisory provides relief from several requirements under the Commodity Exchange Act to registered CPOs that operate offshore commodity pools, including the requirement to maintain records at the CPO’s main business office. We have reviewed the Advisory and believe the relief it provides with respect to recordkeeping would not work well for registered investment companies. We believe that the relief we request, which is modeled on the relief granted to commodity ETFs, is a better fit. The relief granted in the Advisory, for example, requires that the CPO maintain the original books and records of the commodity pool at the main office of the commodity pool. Large investment company complexes typically have multiple offices and may not maintain records at the main office. Rather, it is common practice, and permitted explicitly by the Investment Company Act and the Investment Advisers Act, for records to be maintained by professional third-party service providers.

3. Do Registered Investment Companies Also Need Relief from the Investor Access Requirements?

Participants at the roundtable also discussed whether the requirement in Rule 4.23 under the Commodity Exchange Act that commodity pool investors have access to the CPO’s books and records would raise a concern for investment companies. We believe that such access would raise a serious concern about “selective disclosure,” or disclosure only to certain third parties, of the investment company’s non-public investment holdings.

Registered investment advisers are required to maintain policies and procedures to prevent the misuse of material, nonpublic information, which may include information about current holdings, valuations of, and transactions in instruments held by investment companies they manage.<sup>36</sup> Registered open-end investment companies (“mutual funds”) are required to disclose in their registration statements and on their websites their policies and procedures with respect to disclosure of the investment company’s portfolio holdings and any ongoing arrangements to make available information about the company’s portfolio securities.<sup>37</sup> Selective disclosure is a concern because it “can facilitate fraud and have severe, adverse ramifications for a fund’s investors if someone uses . . . portfolio information to trade against the fund, or otherwise uses the information in a way that would harm the

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<sup>35</sup> See Advisory 18-96, Comm. Fut. L. Rep. (CCH) ¶126,659 (Apr. 11, 1996).

<sup>36</sup> Section 204A of the Investment Advisers Act.

<sup>37</sup> Items 9(d) and 16(f) of Form N-1A.

fund.”<sup>38</sup> The SEC has stated that “[d]ivulging nonpublic portfolio holdings to selected third parties is permissible only when the fund has legitimate business purposes for doing so and the recipients are subject to a duty of confidentiality, including a duty not to trade on the nonpublic information,”<sup>39</sup> a duty to which fund investors typically would not be subject. While we understand, from the discussion at the roundtable, that commodity pool investors have not often exercised their right to access the CPO’s books and records, the concern regarding selective disclosure is serious. It is a greater risk with respect to mutual funds than commodity pools because mutual funds, unlike commodity pools, offer daily liquidity and therefore are more vulnerable to market timing and other practices that rely on the ability to arbitrage the price of a mutual fund’s portfolio holdings. Moreover, knowledge of a mutual fund’s holdings on a real-time basis can result in front-running of those holdings, to the detriment of the fund’s shareholders.<sup>40</sup> We therefore request relief, on behalf of our members, from the investor access provision of Rule 4.23.

#### B. Past Performance Information

Roundtable participants discussed the conflicting requirements to which advisers to registered investment companies could be subject regarding disclosure of past performance information. In brief, CFTC rules require a CPO to include past performance of the pool in its disclosure documents and, in some instances, the CPO’s other pools and accounts (generally for pools with fewer than 3 years of actual performance).<sup>41</sup> Registered investment companies, by contrast, are generally limited to showing performance only for periods subsequent to the effective date of their registration statement, although the SEC staff has permitted them, under very limited circumstances, to include performance information for other investment companies or accounts managed in a substantially similar manner.<sup>42</sup>

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<sup>38</sup> See *Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings*, Investment Company Act Release No. 26418 (Apr. 16, 2004). We note that registered investment companies are required to disclose their portfolio holdings publicly in a quarterly report that is filed 60 days after the close of the first and third quarters, as well as in their annual and semi-annual reports to shareholders, which are required to be sent to shareholders within 60 days after the close of the reporting period.

<sup>39</sup> *Id.*

<sup>40</sup> See, e.g., Letters from Paul Schott Stevens, President, ICI, to Christopher Cox, Chairman, SEC, dated Sept. 14, 2005, Aug. 29, 2006, and Sept. 29, 2008, available at [http://www.ici.org/pdf/comment\\_leakage\\_05.pdf](http://www.ici.org/pdf/comment_leakage_05.pdf); [http://www.ici.org/pdf/comment\\_leakage\\_06.pdf](http://www.ici.org/pdf/comment_leakage_06.pdf); [http://www.ici.org/pdf/comment\\_leakage\\_08.pdf](http://www.ici.org/pdf/comment_leakage_08.pdf).

<sup>41</sup> See Rules 4.24(n) and 4.24(h) under the Commodity Exchange Act.

<sup>42</sup> See, e.g., *Nicholas-Applegate Mutual Funds*, SEC No-Action Letter (Aug. 6, 1996) (SEC staff permitted portfolios of a registered investment company to include in their prospectuses information concerning the performance of certain private accounts managed by the investment company’s adviser beyond the first year of the investment company’s operations, provided, among other things: (i) the performance was for all of the adviser’s private accounts that were managed with investment objectives, policies, and strategies substantially similar to those used in managing the portfolio; (ii) the relative sizes of the portfolio and the private accounts were sufficiently comparable to ensure the private account performance would

How Could the Conflicting Requirements be Reconciled?

In order to reconcile these differing requirements, we suggest that registered investment companies that are unable to rely on amended Rule 4.5 and would be required by Rules 4.24(n) and 4.24(h) under the Commodity Exchange Act to include past performance information in their disclosure documents be granted relief to permit them to include in their prospectuses only that past performance information that is permitted by the SEC staff. We believe this solution would address the Commission's regulatory objective in providing information to pool investors regarding a CPO's experience managing other pools or accounts when the CPO has a limited performance history. At the same time, it would address the SEC's concern that past performance information may be misleading to investors or obscure or impede their understanding of information about a registered investment company under certain circumstances.<sup>43</sup> We also note that, if an investment adviser CPO were required to disclose all past performance information mandated by Rules 4.24(n) and 4.25, an adviser that is part of a large investment company complex could be obligated to disclose information about an enormous number of other investment companies and accounts, most of which information would not be relevant to investment company investors. We do not believe this is the result that these rules were intended to achieve.

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be relevant to an investor; (iii) the prospectus clearly disclosed that the performance information was related to the adviser's management of private accounts and that such information should not be interpreted as indicative of the portfolio's future performance; and (iv) the private account performance would be updated no less frequently than annually); Bramwell Growth Fund, SEC No-Action Letter (Aug. 7, 1996) (SEC staff permitted an investment company to include in its prospectus, in addition to total return information for the investment company, performance information relating to another open-end investment company for which the fund's portfolio manager previously served as portfolio manager under circumstances including that the prior investment company had investment objectives, policies, and strategies that were substantially similar in all material respects to those of the investment company).

<sup>43</sup> See, e.g., Nicholas-Applegate Mutual Funds, , *supra* note 42.



Mr. David A. Stawick

July 28, 2011

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We appreciate the challenging task the staff and Commission face in considering whether additional regulation is necessary in this area and, if so, what the parameters of that regulation should be. If the staff or Commission would like more information about any of the topics discussed in this letter, or if we may be of assistance in any other way, please feel free to contact us. I can be reached at 202/326-5815, or you can reach Sarah Bessin at 202/326-5835 or Rachel Graham at 202/326-5819.

Sincerely,

/s/

Karrie McMillan  
General Counsel

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

Mr. Kevin P. Walek, Assistant Director  
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