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VIA FEDERAL EXPRESS AND E-MAIL

July 27, 2011

Gary Gensler
Chairman CFTC
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Proposed "Eligible Contract Participant" Definition Revisions Applicable to Commodity Pools

Dear Chairman Gensler:

We respectfully write on behalf of our client, Sandalwood Securities, Inc., ("Sandalwood"), a fund-of-funds ("FOF") manager, regarding the Commodity Futures Trading Commission's (the "CFTC") proposed Rule 1.3(m)(5) (the "Proposed Rule"), which provides for significant changes to the Commodity Exchange Act's (the "CEA") "eligible contract participant" ("ECP") definition.[1] Sandalwood is registered with the Securities and Exchange Commission ("SEC," together with the CFTC, the "Commissions") as a registered investment adviser and has been in business for more than 20 years. It currently advises 10 funds which, in aggregate, have approximately $1 billion in assets. Sandalwood's investor base is primarily comprised of high net worth individuals and families and family offices.

The Proposed Rule, which would require a private fund's investors to be ECPs themselves in order for the fund to qualify as an ECP, will result in unfortunate and unintended consequences, including but not limited to, the likelihood that many FOFs will no longer qualify as ECPs for purposes of over-the-counter foreign exchange ("OTC FX") transactions, thus subjecting them to more stringent regulations applicable to "retail" investors. If FOFs are forced to engage in FX transactions on exchanges or only with select counterparties because they do not qualify as ECPs, FOF managers will have to alter their funds' portfolio construction resulting in a substantial disruption of the business practices in which they have engaged for years, and the FOFs and their investors will incur increased costs associated with moving and maintaining their trades on exchanges or with select counterparties. Alternatively, these funds will be forced to redeem investors (many of whom are long-term investors) who no longer qualify as investors in the fund in order for the fund to remain eligible to continue to participate

[1] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80174 (Dec. 21, 2010).

in the OTC FX market. We think that the Proposed Rule, as drafted, is contrary to Congress' intent in revising the ECP definition in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") because it goes significantly beyond the changes mandated by the Dodd-Frank Act. We therefore respectfully request that the CFTC consider narrowing the scope of the Proposed Rule so that it is better tailored to achieve the reforms sought by Congress, without causing unnecessary and unintended consequences.

In order to put these issues in the proper regulatory perspective, it is important to note that (i) Sandalwood is (and many other similarly situated managers of or advisers to FOFs are) registered with the SEC as an investment adviser, and (ii) the hedge funds into which the Sandalwood FOFs invest are primarily engaged in the trading of securities. The underlying hedge funds and the Sandalwood FOFs are commodity pools primarily because of the use by underlying managers, largely for hedging purposes, of both foreign currency forwards, as well as certain swaps and futures.

We understand that in the past there have been unfortunate abuses by dishonest commodity pool operators in the OTC FX markets and applaud Congress for enacting revisions to the CEA through the Dodd-Frank Act which will better protect less sophisticated retail investors from abuse by limiting permissible FX trading to regulated exchanges. We appreciate the fact that, as part of its goal to provide additional protections to unsuspecting unsophisticated investors, Congress wanted to prevent commodity pools comprised primarily of such unsophisticated investors from qualifying as an ECP, which would otherwise exempt them from many of the stringent requirements meant to protect such unsophisticated "retail" investors. Congress effectuated this goal by revising CEA Section 1a(12)(A)(iv), requiring all investors in commodity pools to be ECPs themselves in order for the commodity pool to obtain the ECP designation. While we believe that the notice of proposed rulemaking issued by the Commissions which clarifies "entity" definitions, such as the ECP definition, is an extremely important and necessary step to implement the Dodd-Frank Act, the specific Proposed Rule, as applied to hedge funds and FOFs, will adversely affect the hedge fund industry as a whole, as discussed below.

FOF entities have a range of both U.S. and non-U.S. investors and primarily invest in other private investment vehicles.[2] Because most such private investment vehicles accept investments only in U.S. Dollars, in order to accommodate the many non-U.S. FOF investors that wish to invest in FOFs using their own non-U.S. Dollar currencies, FOFs typically convert the foreign currency to U.S. Dollars before investing in the private investment vehicles. FOFs typically hedge the exchange rate risk on behalf of their non-U.S. investors through various OTC FX transactions such that the rate of exchange will not impact the value of the non-U.S. investors' shares in the FOF. The Proposed Rule, which imposes a look-through requirement that would require all investors in the FOF to be ECPs in order for the FOF commodity pool to

[2] Note that a non-U.S. person qualifies as a qualified eligible person without regard to income or asset qualifications (17 C.F.R § 4.7(a)(2)(xi)) whereas non-U.S. persons do not qualify as eligible contract participants unless they meet the same qualification standard as U.S. persons (7 U.S.C § 1a(12)).

qualify as an ECP itself, would have the unintended consequence of requiring FOFs to choose between redeeming all investors that are not ECPs, a group which for some managers is a large portion of their investor base, or being deemed a non-ECP, subjecting the FOF to the more restrictive retail regulations, including restrictions regarding off-exchange transactions. Therefore, the Proposed Rule will clearly disrupt the typical operations of FOFs, requiring FOFs to choose to redeem non-ECP investors or else lose their ECP status, which would prohibit them from hedging currency exposure through OTC FX, and likely result in them losing their non-U.S. investor base through redemptions, incurring substantial costs due to engaging in FX transactions on exchanges or with select counterparties, and altering their portfolio construction in order to address these factors.[3] As discussed below, we do not think that Congress's intent was to disrupt the hedge fund industry to this extent; rather, we think that in amending CEA Section 1a(12)(A)(iv) through the Dodd-Frank Act, Congress meant only to provide protection for unsophisticated investors while leaving open other avenues under the broader CEA ECP definition through which hedge funds and FOFs could obtain ECP status by meeting other relevant thresholds.

While the use of OTC FX instruments by a FOF is generally limited to hedging transactions, the underlying hedge funds into which a FOF may invest may engage in a broad range of transactions involving the trading of currencies, both for hedging and for speculative purposes. The FOF has no ability to control such trading, and in most cases, no knowledge of the day to day trading activities of the hedge fund. If a FOF is unable to qualify as an ECP because it has one or more investors who are not ECPs, the FOF would either be ineligible to invest in the hedge fund, or the hedge fund would be prohibited from utilizing the full range of instruments which may be appropriate to express an investment idea.

The CEA ECP definition sets forth a variety of distinct categories through which individuals or entities can qualify as ECPs. Hedge Funds and FOFs have historically relied on two CEA sections to qualify as ECPs:

CEA Section 1a(12)(A)(iv)[4]
This CEA Section generally states that a commodity pool with $5,000,000 in assets that was formed and is operated by a person subject to CFTC or similar foreign regulation is an ECP for purposes of all transactions.

CEA Section 1a(12)(A)(v)[5]
This CEA Section generally states that a corporation, partnership, proprietorship, organization, trust or other entity acting for its own account is an ECP if it has total assets exceeding $10,000,000.

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[3] OTC FX transactions are preferable to exchange-traded futures contracts for FOFs for several factors, including but not limited to, the difficulty posed to FOFs by the margin requirements of exchange-traded contracts; FOFs generally lack the daily liquid capital that is required for such requirements.
[4] 7 U.S.C. § 1a(12)(A)(iv).
[5] 7 U.S.C. § 1a(12)(A)(v).

The Dodd-Frank Act amended section 1a(12)(A)(iv), providing that a commodity pool will not qualify as an ECP with respect to certain FX transactions unless all of the commodity pool's participants are themselves ECPs.[6] The Dodd-Frank Act did not add a look-through requirement to any of the other ECP definition categories. The Commissions, through a series of proposed rules, now seek to clarify several of the Dodd-Frank Act's "entity" definitions. One of the proposed rules, the Proposed Rule at issue, seeks to modify all of CEA Section 1a(12), not just section 1a(12)(A)(iv). The Proposed Rule states that, with respect to certain FX transactions, *both direct and indirect* commodity pool investors must qualify as ECPs in order for the commodity pool in which they are invested to meet the ECP definition.[7]

As discussed above, the Proposed Rule extends Dodd-Frank's limited look-through requirement to all sub-sections of section 1a(12). As a result, hedge funds and FOFs would not qualify as ECPs under either 1a(12)(A)(iv) or 1a(12)(A)(v), unless all of their direct and indirect investors are also ECPs. We believe that this result was neither mandated nor intended by Congress in enacting the Dodd-Frank Act. This revision would require affirmative ECP representations from each investor (a "Direct Investor") in a hedge fund or FOF, and would also require such representations from any entities or persons invested in such Direct Investor and so on; this look-through analysis would continue until it reached individual natural persons, at which point the analysis would consider whether such natural persons qualify as ECPs.

The proposed look-through would be extremely problematic for many hedge funds and FOFs as many of their Direct Investors, and many investors of such Direct Investors, do not qualify as ECPs. Many current FOF investors are knowledgeable employees or sophisticated high net worth individuals who satisfy the eligibility requirements under other longstanding statutory schemes (e.g., qualified purchasers under Section 2a-51 of the Investment Company Act), but would not meet the new ECP definition, which requires individuals to have amounts in excess of $10 million invested on a discretionary basis. As a result, as discussed above, if the Proposed Rule is enacted, both hedge funds and FOFs that wish to continue to qualify as ECPs in order to avoid the stringent restrictions on OTC FX trading applicable to non-ECPs, will be forced to redeem many current investors that do not meet the ECP definition and going forward will potentially be forced to forgo a substantial part of their current investor base. We therefore strongly disagree with the Commissions' statements that the Proposed Regulation "is in line

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[6] This look-through is only applicable when determining a commodity pool's ECP status under CEA sections 2(c)(2)(B)(vi) and 2(c)(2)(C)(vii). Section 2(c)(2)(B)(vi) states that the CEA applies to and the CFTC shall have jurisdiction over any pooled investment vehicles that engage in the retail foreign currency transactions described in Section 2(c)(2)(B)(i). Section 2(c)(2)(C)(vii) states that the CEA applies to and the CFTC shall have jurisdiction over any pooled investment vehicles that engage in foreign currency transactions described in Section 2(c)(2)(C)(i). For specifics on the look-through, see Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203. Note that section 741(b)(10) of the Dodd-Frank Act renumbered the CEA ECP definition from section 1a(12) to section 1a(18).

[7] 75 Fed. Reg. at 80212. Proposed Rule 1.3(m)(5) states: "A commodity pool with one or more direct or indirect participants that is not an eligible contract participant is not an eligible contract participant for purposes of Sections 2(c)(2)(B)(vi) and 2(c)(2)(C)(vii) of the Commodity Exchange Act."

with the expectations of market participants and would impose virtually no costs while providing the benefit of greater certainty."[8]

We understand that the CFTC's rationale for the Proposed Rule is that it is concerned that retail foreign exchange commodity pools may circumvent section 1a(12)(A)(iv)'s limited look-through by instead relying on other categories of the ECP definition.[9] We also appreciate that the CFTC wants to protect direct and indirect commodity pool investors from potential fraudulent activity perpetrated by pool operators and therefore, with the goal of making sure that such investors are sophisticated enough to make such investments, take the view that pool investors should have to meet certain thresholds in order to invest in such vehicles. However, we believe that expanding the look-through requirement, with the goal of preventing commodity pools from qualifying as ECPs under various sections of 1a(12) or as a mechanism to establish a type of "sophistication threshold" requirement throughout all ECP categories, is contrary to Congress' intent as set forth in the Dodd-Frank Act and out of step with existing regulatory protections which have served investors well. If Congress had wanted the look-through to apply to all of the ECP categories, it would have expressly added this look-through language to each category or added it to a new catch-all type provision in the ECP definition.

Because we do not believe that the Proposed Rule corresponds with Congress' intent as set forth in the Dodd-Frank Act, and because it will greatly impact the operations of FOF commodity pools, we urge the CFTC to consider several alternatives to the Proposed Rule which are less disruptive to a FOF's portfolio construction and investor base, among other concerns, and preserve the ability of a hedge fund or FOF which is comprised of sophisticated investors to continue to actively participate in the OTC FX market. We recommend the following alternatives, all of which avoid the problems caused by the Proposed Rule discussed above:[10] (1) specifically allow FOFs to rely on different categories set forth in the CEA's ECP definition, such as section 1a(12)(A)(v) (which some FOFs may currently rely upon), without the look-through requirement. In order to prevent unscrupulous managers who target retail investors from relying upon this exemption, we have no objection to establishing a requirement that a fund have in excess of $10 million in investments, or a minimum investment requirement (e.g., $100,000); (2) define non-U.S. persons as ECPs; and (3) clarify that commodity pools will qualify as ECPs if such commodity pool investors all meet other more common eligibility criteria that already serves as a "sophistication threshold" for many funds. Examples of such criteria are the "accredited investor" requirement as defined under Rule 506 in Regulation D under the Securities Act of 1933, as amended, or "qualified eligible person" requirement as defined in CFTC Rule 4.7. If the minimum eligibility requirement for investors in a hedge fund or FOF are modified to bring them in line with other existing requirements (as described above),

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[8] 75 Fed Reg. at 80203.

[9] 75 Fed. Reg. at 80185.

[10] These provisions are examples of recommendations set forth in more detail in Sidley Austin LLP's letter to the Commissions, dated February 22, 2011. The letter provides an excellent summary of the impact of the Proposed Rule on FOFs and detailed recommendations, some of which are summarized above, to help mitigate the impact of the Proposed Rule on such commodity pools.

we fully support a rule which would require hedge funds and FOFs to satisfy the new ECP standard by having at least $10 million in investments.

We greatly appreciate the CFTC's consideration with regard to the foregoing comments and would be happy to discuss our comments and recommendations at any time. If we can provide any additional information that may assist you in considering our request, please contact me at 212-698-3570 or george.mazin@dechert.com.

Respectfully submitted,

George J. Mazin

GJM

cc: Martin J. Gross
Sandalwood Securities, Inc.