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KISS Initiative – Appendix 1

REGISTRATION[1]

I. CPO and CTA Registration and Regulation: Eliminate Unnecessary Burdens on SEC-Registered Investment Advisers and Improve Clarity of Requirements

A. Commission's Regulatory Goals

The Commodity Futures Trading Commission (the "Commission") has long recognized the importance of harmonizing the regulations imposed on dually regulated entities in order "to eliminate duplicative and unnecessary regulatory burdens."[2] In applying this principle, the Commission has acknowledged that regulation of asset managers and funds by the Securities and Exchange Commission (the "SEC") seeks to fulfill many of the same regulatory goals in the area of investor protection as the Commission's regulation of commodity pool operators ("CPOs") and commodity trading advisers ("CTAs").[3] In particular, the Commission has recognized that the SEC's disclosure, reporting, and recordkeeping rules governing registered investment companies "were designed to achieve substantially similar goals to those of the Commission's part 4 regulations."[4]

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2 *See* Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons From the Definition of the Term "Commodity Pool Operator"; Other Regulatory Requirements, 50 Fed. Reg. 15,868, 15,870 (Apr. 23, 1985).

3 *See* Commodity Pool Operators and Commodity Trading Advisors; Exemption From Registration and From Subpart B of Part 4 for Certain Otherwise Regulated Persons and Other Regulatory Requirements, 49 Fed. Reg. 4778, 4783 (Feb. 8, 1984) ("The Commission believes that the other regulatory frameworks to which the persons and qualifying entities specified in the proposed § 4.5 are subject generally address the purposes of the prohibitions contained in § 4.20.").

4 *See* Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators, 78 Fed. Reg. 52,308, 52,310 (Aug. 22, 2013).

B. Excessive Regulatory Burdens and Adverse Impact

Since 2012, the Commission's regulations, as interpreted by the agency and its staff, have (1) unnecessarily required CPO registration for many SEC-registered asset managers, creating an inefficient regime of dual SEC and CFTC registration and (2) imposed overly burdensome and unnecessary ongoing regulatory requirements on SEC-registered investment advisers ("RIAs") that are also required to register as CPOs and CTAs.

In addition, uncertainty around the Commission's interpretation of Section 4m(3) of the Commodity Exchange Act ("CEA"), the statutory CTA exemption for SEC-registered investment advisers that are not engaged primarily in providing CTA advice and do not advise pools that are engaged primarily in trading commodity interests, may discourage SEC-registered advisers from relying on the exemption to the full extent intended by Congress and thus undermine the Congressional goal of avoiding unnecessary burdens imposed by dual CFTC and SEC registration.

1. Commission's Reversal of SEC-Registered Investment Adviser Exclusions/Exemptions Previously in Commission Regulations 4.5 and 4.13(a)(4)

a. Adoption and Early History

The Commission originally adopted Regulation 4.5 in 1985 to avoid unnecessary and duplicative CPO regulation by the Commission of entities that were already subject to extensive state or Federal regulation, including registered investment companies ("RICs") under the Investment Company Act of 1940 ("'40 Act") and other categories of "otherwise regulated entities." To that end, Regulation 4.5 provided an exclusion from the definition of CPO (and thus from registration and regulation as such) for a number of categories of "otherwise regulated entities," including RICs. At the time, the exclusion was subject to a *de minimis* trading limit and a marketing restriction with respect to the activities of the otherwise regulated entity in commodity futures and commodity options.[5]

[5] Regulation 4.5 was proposed and adopted pursuant to a report of the Senate Committee on Agriculture, Nutrition, and Forestry, which directed the Commission to issue regulations that would have the effect of providing relief from regulation as a CPO for certain otherwise regulated entities, and provided specific parameters. This direction from the Committee, submitted in connection with the adoption of the Futures Trading Act of 1982, was in lieu of a statutory exemption that the Committee had considered but decided not to adopt based on information provided by the Commission. In 1984, the Commission proposed a CPO exemption that closely followed the specific parameters of the Committee report, but ultimately adopted a rule that provided an exclusion instead of an exemption and generally provided more expansive relief than the proposal. *See* Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Pool Operator"; Other Regulatory Requirements, 50 Fed. Reg., 15,868 (April 23, 1985) ("Regulation 4.5 1985 Adopting Release"). Throughout

In 2003, the Commission adopted changes that further reduced overlapping regulation by (1) effectively removing RICs and the other otherwise regulated entities from the Commission's CPO regulatory regime and (2) providing a broad CPO registration exemption available for RIAs of certain privately offered funds. Both changes were intended to allow greater flexibility and innovation that would, in turn, encourage broader market participation and ultimately greater market liquidity, to the benefit of all market participants.[6]

Specifically, the Commission determined to remove the trading and marketing tests in Regulation 4.5. At the same time, the Commission adopted a new exemption, Regulation 4.13(a)(4), for operators of private funds sold only to qualified institutional and high net worth investors meeting heightened sophistication and eligibility standards.[7] Like amended Regulation 4.5, Regulation 4.13(a)(4) did not impose a commodity interest trading test or marketing test. In the Commission's own words:

> [The expanded exemptive provisions were] intended to allow greater flexibility and innovation, and to take into account market developments and the current investment environment, by modernizing the requirements for determining who should be excluded from the CPO definition, and who should remain within

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the next decade, the Commission made a number of changes to the rule expanding the relief provided, for example, by amending the trading test to permit an unlimited amount of bona fide hedging and adding flexibility to the concept of bona fide hedging. *See, e.g.*, Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Pool Operator," 58 Fed. Reg. 6371 (Jan. 28, 1993).

6 See Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues, 68 Fed. Reg. 47,221 (Aug. 8, 2003). The 2003 rulemaking was in response to Section 125 of the Commodity Futures Modernization Act of 2000, which required the Commission to "conduct a study of the [Act] and the Commission's rules, regulations and orders governing the conduct of persons required to be registered under the Act." Following this directive, the Commission conducted the study, issued its findings, held a "Roundtable on CPO and CTA Issues," issued an Advance Notice of Proposed Rulemaking followed by a proposed rule, and after considering comments made in all these proceedings, adopted the 2003 changes. This history is described in the release accompanying the proposal for the 2003 changes. *See* Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors, 68 Fed. Reg. 12,622 (March 17, 2003) ("Regulation 4.5 2003 Proposing Release").

7 Regulation 4.13(a)(4) was one of two new CPO exemptions for operators of private funds adopted in 2003 in order to expand the existing CPO exemptions for such operators, which were viewed as overly restrictive, thus causing some operators of collective investment vehicles to avoid participation in the commodity interest markets. At the same time, the Commission also adopted Regulation 4.13(a)(3), which provided a narrower exemption for private funds sold to a broader group of investors. Regulation 4.13(a)(3) imposed trading and marketing tests similar (although not identical) to those that had previously been incorporated in Regulation 4.5.

> the CPO and CTA definitions but be exempt from registration. Thus, this relief is intended to encourage and facilitate participation in the commodity interest markets by additional collective investment vehicles and their advisers, with the added benefit to all market participants of increased liquidity.[8]

b. Changes in 2012

In 2012, the Commission once again amended Regulation 4.5, largely undoing the exclusion of RICs and their advisers from regulation as CPOs under part 4 of the Commission's regulations and adding onerous requirements for those seeking exclusion.[9] The Commission also repealed Regulation 4.13(a)(4). As a result of these changes, RICs and privately offered funds advised by RIAs must comply with two conditions relating to their activities in commodity interests – a *de minimis* trading test and a marketing test – in order to qualify (or for their advisers to qualify) for the CPO exclusion or exemption (for simplicity, we refer to them together as exemptions).[10] If the RIC or private fund fails either test, the RIA must register with the Commission as a CPO, become a member of the National Futures Association ("NFA"), and comply on an ongoing basis with applicable Commission and NFA regulatory requirements applicable to CPOs.

Also during this time-period, the definition of commodity interests was broadened to include swaps and other financial instruments, in addition to futures and commodity options. This development dramatically magnified the impact of the changes to Regulation 4.5 and the repeal of Regulation 4.13(a)(4).[11] Many more SEC RIAs, both to RICs and private funds, found themselves

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8 Regulation 4.5 2003 Proposing Release, *supra* note 6.

9 *See* Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg., 11,252 (Feb. 24, 2012) ("Regulation 4.5 2012 Adopting Release"). Unlike the original adoption of Regulation 4.5 and the 2003 amendments, the 2012 amendments were not required by a direction from Congress. The Commission's 2012 amendments to Regulation 4.5 were a response to an NFA petition filed in 2010, urging the Commission to reinstate for RICs the two conditions that had, a decade earlier, imposed limits on commodity futures and commodity options trading. The NFA had become concerned that a small number of RICs were operating as managed futures funds outside of the Commission's and its own jurisdiction. *See* NFA Letter Petitioning for Rulemaking to Amend Regulation 4.5, *available at* https://www.nfa.futures.org/news/newsPetition.asp?ArticleID=3630 (Aug. 18, 2010) ("NFA Petition").

10 In the absence of Regulation 4.13(a)(4), the only CPO exemption available for RIAs to private funds is Regulation 4.13(a)(3), which, as discussed below, imposes commodity interest trading and marketing tests similar to those in amended Regulation 4.5.

11 This impact was further magnified in combination with Commission and staff statements to the effect that a pooled vehicle holding a single swap is presumptively a commodity pool. *See, e.g.,* Regulation 4.5 2012 Adopting Release, *supra* note 9, at 11,258 ("As a result, one swap contract would be enough to trigger the registration requirement."). This interpretation, our reasons for considering it overbroad and inconsistent

to be operators or advisers of funds that were deemed to be commodity pools, and thus in need of an exemption in order to avoid dual regulation by the Commission as well as the SEC, yet the available exemptions had been substantially narrowed. In addition, because of the expansion of the term "commodity interest," many more RIAs were considered CTAs and thus subject to registration and regulation as such absent an available CTA exemption.[12]

c. Increased Regulatory Burdens Resulting from 2012 Changes

The increased regulatory burdens from the 2012 changes have been substantial for SEC-registered and regulated entities. Importantly, these changes now impose ongoing burdens on RICs, private funds, and RIAs whether or not CPO registration for the relevant entity is ultimately required. The mere existence of the trading and marketing conditions now requires all funds to analyze, and monitor on an ongoing basis, whether they meet both of the tests. This in itself is a burdensome, costly, and labor intensive process, which is exacerbated by ambiguities and subjective terms embedded in many of the regulations' provisions. Also, RIAs operating funds that do not meet both tests are required to register as CPOs. To its credit, in the case of RICs, the Commission recognized the dangers of dual regulation and adopted harmonization exemptions for some of the requirements otherwise applicable to CPOs for RICs. These harmonization standards permit CPOs of RICs to rely on substituted SEC compliance for most Part 4 disclosure and shareholder reporting requirements. However, the harmonization standards do not go far enough. Many significant areas of CPO regulation are not harmonized for RIC CPOs, including, among others, recordkeeping requirements, regulatory reporting on Form CPO-PQR, and compliance with many NFA rules. Moreover, there are no harmonization rules for RIAs to private funds or for RIAs that must register as CTAs.

The 2012 amendments were an abrupt reversal of the Commission's policy, which had been aimed at achieving efficiencies through avoiding duplication, as well as improving liquidity in the markets by encouraging broader market participation. The amendments also went far beyond the NFA's petition that had initiated the review of Regulation 4.5, which was to reinstate prior limits on futures and commodity options trading for funds sold to retail investors. As stated in the NFA petition:

> NFA is interested in ensuring that registered investment companies that engage in more than a *de minimis* amount of futures trading and that are offered to retail customers <u>or</u> are

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with Congressional intent, and the excessive regulatory burdens resulting from such an interpretation are discussed in Part II of this submission.

12 Excessive regulatory burdens caused specifically by overly narrow interpretations of the statutory CTA exemption for RIAs are discussed in Part B of this Section.

> marketed to retail customers as a commodity pool or otherwise as or in a vehicle for trading in (or otherwise seeking investment exposure to) the commodity futures or commodity options markets are subject to the appropriate regulatory requirements and oversight by regulatory bodies with primary expertise in commodity futures. NFA believes that requiring persons that market commodity funds to the retail public and whose funds engage in more than a *de minimis* amount of futures trading or investment to be registered as commodity pool operators ("CPOs") furthers that goal.[13]

Because of the expansion of the term commodity interest under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act" or "Dodd-Frank") and the Commission's broad interpretation of the term commodity pool, Regulation 4.5 as adopted has imposed limits on many types of funds that engage in no futures trading at all, and from an impact standpoint cannot in any sense be properly viewed as imposing "the same operating restrictions on registered investment companies that were in place prior to 2003," as the NFA had requested. Moreover, the NFA had not asked the Commission to repeal Regulation 4.13(a)(4), recognizing that funds sold only to qualified purchasers did not pose the public interest concerns that led to its petition, which the NFA viewed as a "critical distinction."

In reversing its 2003 policy decision, the Commission did not explain how severely narrowing the available CPO exclusions and exemptions for RICs and RIAs would serve its original goals—allowing greater flexibility and innovation and providing all market participants the benefit of increased liquidity. In fact, the 2012 actions have impeded these goals, and returning to the expanded exemptions would once again foster the flexibility, innovation, and market liquidity that the Commission has historically seen as beneficial to investors and the markets.[14]

d. Additional Ambiguities After 2012 Changes Causing Further Burdens

Even assuming that incorporating trading and marketing tests into the exemptions available for RIAs to RICs and private funds were appropriate, several areas of ambiguity and subjectivity in

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13 *See* NFA Petition, *supra* note 9 (emphasis in original).

14 We recognize that the Commission also has important regulatory goals in preventing manipulation and other types of fraud in the markets it regulates and seeks to ensure that it has the information necessary to fulfill its regulatory mission. However, expanding the exemptions for RIAs would not result in sacrificing the Commission's anti-manipulation and anti-fraud jurisdiction over these entities, and, after Dodd-Frank, the Commission has substantially expanded regulatory authority to collect the necessary market information.

the exemptions, as currently in effect, create uncertainty that operates to force more RIAs into CPO registration than is warranted by the goals of the rules. This uncertainty blurs the boundaries of where the exemptions apply, thus creating a "chilling effect" on entities that want to ensure compliance and, in turn, the danger of capturing more already regulated entities within the Commission's jurisdiction than was intended. Expanding the registration requirement beyond the Commission's goals makes the criteria of the exemptions too restrictive for many operators of collective investment vehicles to meet. As the Commission recognized in 2003, while adding commodity interest trading to traditional securities trading strategies can benefit investors, forcing asset managers to register with the Commission under overly restrictive conditions may cause asset managers to refrain from providing any such commodity interest advice, which in turn would both decrease liquidity in the markets and deprive investors of potentially beneficial strategies.[15]

Three areas of uncertainty currently exist for which interpretive guidance could reduce excessive registration as well as the costs and burdens of monitoring for compliance.

First, the outdated Regulation 4.5 definition of bona fide hedging has not been aligned with current Commission views and the Commission has not incorporated a bona fide hedging exclusion into Regulation 4.13(a)(3). Regulation 4.5 excludes from the *de minimis* trading limits commodity interest positions that are used for "bona fide hedging." The purpose of this exclusion was to allow investors to benefit from risk reducing strategies used in connection with securities trading, without imposing the unnecessary burdens of CPO regulation. However, the definition of bona fide hedging currently used for purposes of Regulation 4.5 is both too narrow for this purpose and out of step with current Commission thinking on bona fide hedging.

The history of the current bona fide hedging definition in Regulation 4.5 bears some explanation. Several months after the 2012 amendment of Regulation 4.5, the definition of bona fide hedging included in the amended rule was vacated by a federal court.[16] The Commission staff

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15 *See* Regulation 4.5 2003 Proposing Release, *supra* note 6, at 12,624-25, noting that "[o]ver time, persons who traditionally gave advice to collective investment vehicles solely on securities trading have become interested in providing trading advice to collective investment vehicles on commodity interest contracts based on various financial instruments as well. Absent the availability of an exemption, these persons have had to either register with the Commission as CTAs or refrain from providing any such commodity interest advice."). The Commission also noted, quoting from the Advance Notice of Proposed Rulemaking, that some operators of collective investment vehicles had avoided participation in the commodity interest markets because the criteria of Regulation 4.5 and other existing exemptions were too restrictive for many operators of collective investment vehicles to meet.

16 *See* International Swaps & Derivatives Ass'n v. CFTC, 887 F.Supp.2d 259 (D.D.C. 2012) ("*ISDA v. CFTC*"). Regulation 4.5, as amended in February of 2012, incorporated the definition of bona fide hedging as it was set forth at the time in CFTC Regulations 1.3(z)(1) and 151.5. These definitions had recently been adopted (in the case of Regulation 151.5) and amended (in the case of Regulation 1.3(z)(1)) by the Commission as part of its rules imposing position limits for certain commodity futures and economically equivalent swaps (the "position limits rules"), issued in November 2011. *See* Position Limits for Futures and

then revived the vacated definition of bona fide hedging for purposes of Regulation 4.5 by means of an interpretative letter.[17] Subsequently, the Commission reconsidered the appropriate scope of bona fide hedging in other contexts, and recognized the appropriateness of making the definition more flexible and incorporating concepts of risk management.[18] To date, however, neither the Commission nor the staff has taken steps to replace the vacated, and now outmoded, definition of bona fide hedging that is still required, by no-action letter, to be used for purposes of Regulation 4.5.

The KISS initiative provides an opportunity for the Commission to look at the Regulation 4.5 definition with a clean slate, and replace the guidance provided in the staff letter with an appropriate definition of bona fide hedging that looks to the goals of Regulation 4.5, not to the position limits rules (which were the source of the current vacated definition). At the same time, while Regulation 4.13(a)(3) does not expressly exclude bona fide hedging transactions, this re-evaluation of bona fide hedging should include consideration of guidance applying the concept to Regulation 4.13(a)(3) as well.

Second, the net notional value test does not expressly permit netting of uncleared swaps. Both Regulation 4.5 and Regulation 4.13(a)(3) provide a net notional value test that the fund may meet to satisfy the *de minimis* trading condition. Effectively, the net notional value of the fund's commodity interest trading may not exceed 100% of the fund's liquidation value. The net notional value test recognizes that one way to measure the extent of the fund's exposure through commodity interests is by looking at notional value exposure on a net basis.[19] The purpose of looking at notional value on a net basis is to accurately gauge, and thus avoid overstating, the fund's

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Swaps, 76 Fed. Reg. 71,626 (Nov. 18, 2011) (establishing position limits); Regulation 4.5 2012 Adopting Release, *supra* note 9 at 11,252. In *ISDA v. CFTC*, which was decided in September of 2012, the Court vacated the position limits rules, including the new definition of bona fide hedging in Regulation 151.5 and the amendments to the definition in Regulation 1.3(z).

17 *See* CFTC Interpretative Letter No. 12-19 (Oct. 12, 2012). The Court's vacatur of the bona fide hedging definitions that had been incorporated in Regulation 4.5 left a gap in the rule. On October 12, 2012, the CFTC's DSIO addressed this gap by issuing a letter that effectively incorporated the vacated definitions back into Regulation 4.5. This letter states that DSIO interpreted Regulation 4.5 as continuing to incorporate the substance of the definitions of bona fide hedging as set forth in Regulation 151.5 and amended Regulation 1.3(z) prior to those Regulations being vacated.

18 The Commission has now proposed revised position limits rules, which include revised, and in some ways expanded, definitions of bona fide hedging. *See* Position Limits for Derivatives, 78 Fed. Reg. 75,680 (Dec. 12, 2013); Position Limits for Derivatives: Certain Exemptions and Guidance, 81 Fed. Reg. 38,458 (June 13, 2016) (supplemental notice of proposed rulemaking); Position Limits for Derivatives, 81 Fed. Reg. 96,704 (Dec 30, 2016) (reproposal). The latest proposal to amend the definition of bona fide hedging for purposes of position limits for financial commodities (the type of commodity interest most likely to be relevant for registered funds) expands the definition to include the concept of risk management.

19 Net positions are also mentioned in the marketing test.

exposure so that funds whose commodity interest exposure truly is *de minimis* are not subject to dual regulation.

Thus, the very concept of a "net" notional value test contemplates netting long and short exposures. Moreover, the rule expressly provides for netting of futures and cleared swaps.[20] Contrary to the net notional value concept, however, neither Regulation 4.5 nor Regulation 4.13(a)(3) expressly provides for netting uncleared swaps exposure. This gap in the rules interferes with the purpose of the trading limitation, which is to limit a fund's exposure to the 100% level.[21] Absent the ability to net uncleared swaps, both the long exposure and the short exposure on offsetting risks would have to be counted for purposes of the net notional value test, which could dramatically overstate the fund's actual exposure to the underlying commodity interests. We believe there is no public policy reason to limit netting for purposes of the net notional value test to futures and cleared swaps, while requiring uncleared swaps exposure to be considered on a gross basis.

Third, the current marketing test guidance is vague and over broad. Regulation 4.5 and Regulation 4.13(a)(3) in their current form both impose a marketing test in addition to a trading test. That is, even for funds with *de minimis* commodity interest exposure, the rules require that in order to qualify for the exemption, participations in the fund may not be marketed as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity interest markets.[22]

Neither rule explains what types of activities would constitute marketing as a commodity pool or a vehicle for trading in the relevant commodity interest markets, but the Adopting Release for amended Regulation 4.5 provides a list of factors that the Commission stated "are indicative of marketing a registered investment company as a vehicle for investing in commodity futures, commodity options, or swaps" for purposes of that rule. The factors are:

- The name of the fund;
- Whether the fund's primary investment objective is tied to a commodity index;

20 Funds may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade and may net swaps cleared on the same designated clearing organization, where appropriate.

21 *See* Regulation 4.5 2012 Adopting Release, *supra* note 9, at 11,256.

22 There are differences in the two tests. Regulation 4.5 refers to marketing to the public, and expressly mentions swaps. Regulation 4.13(a)(3) refers only to marketing the fund as a vehicle for trading in the commodity futures and commodity options markets, and does not mention swaps. There is also no indication in the Adopting Release that the marketing factors set out for Regulation 4.5 apply to the marketing test in Regulation 4.13(a)(3), and indeed at least one of them (whether the fund makes use of a controlled foreign corporation) would not apply to private funds (controlled foreign corporations are used by RICs for tax reasons that are unique to RICs).

- Whether the fund makes use of a controlled foreign corporation for its derivatives trading;

- Whether the fund's marketing materials, including its prospectus or disclosure document, refer to the benefits of the use of derivatives in a portfolio or make comparisons to a derivatives index;

- Whether, during the course of its normal trading activities, the fund or an entity on its behalf has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives;

- Whether the futures/options/swaps transactions engaged in by the fund or on behalf of the fund will directly or indirectly be its primary source of potential gains and losses; and

- Whether the fund is explicitly offering a managed futures strategy.

As is clear from the face of the factors, they are generally vague and subjective and a number of them could apply to virtually any fund that engages in derivatives of any type, to any extent, and for any reason. Accordingly, they create substantial uncertainty as to when a fund would be considered marketing itself outside the boundaries of the rule.

To give an example, one of the factors is "whether the fund's marketing materials, including its prospectus or disclosure document, refer to the benefits of the use of derivatives in a portfolio or make comparisons to a derivatives index." Under the federal securities laws, as well as simple common sense, a fund that uses derivatives must certainly refer to this use in its prospectus disclosure.[23] So, any fund claiming the exclusion would automatically fail this part of the test. Moreover, many types of derivatives (for example, equity options and exchange-traded currency options) are not commodity interests. Accordingly, this factor is meaningless as an indicator of whether the fund is marketed in a manner that should require CPO registration. Thus it can only operate to confuse funds trying to make sense of the marketing test and in turn expand the registration requirement beyond any sensible boundary.

Another factor that muddies the test is whether the commodity interest trading engaged in by the fund or on behalf of the fund "will directly or indirectly be its primary source of potential

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23 Appropriate disclosure of fund derivatives activities under the federal securities laws, including adequate risk disclosure, is a matter of substantial concern and vigilance on the part of the SEC and its staff. *See* Disclosure and Compliance Matters for Investment Company Registrants that Invest in Commodity Interests, Investment Management Guidance Update No. 2013-05 (August 2013), *available at* https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-05.pdf ("SEC Derivatives Disclosure Guidance").

gains and losses." As discussed later in Part II.B.3, we believe this factor is intended to capture the intent of the fund sponsor with respect to the primary activity of the fund, based on considerations historically used to determine the status of a particular fund as a commodity pool or an investment company. However, those status considerations refer to anticipated or "looked for" gains and losses, not what "will directly or indirectly" occur in an undefined time frame. For any fund using derivatives, it is impossible to predict whether, at some point, the derivatives transactions may in some sense result in more gains or losses than other factors, especially if the standard is "direct or indirect." That type of exposure is one of the risks funds disclose, under SEC requirements, for any use of derivatives.[24] Again, this factor creates both confusion and the danger of over-inclusion of funds that as an objective matter are conducting only *de minimis* commodity interest trading within the standards of the rule.

More generally, funds governed by the disclosure standards of the federal securities laws are bound by law to disclose their derivatives use in a materially accurate manner, which means that funds engaging in *de minimis* commodity interests trading will ordinarily not be marketing themselves as commodity pools. It is unclear what type of fund, if any, would both qualify for the *de minimis* commodity interest exposure test and yet wish to market itself as a commodity pool. The marketing test overlay on the *de minimis* trading test is, therefore, a regulatory solution without a problem. Thus, the marketing test should be limited in a manner that identifies either egregious over statements of the fund's commodity interest trading or intentional incentives to lure investors in by commodity pool-type marketing.

e. Unnecessary Burdens of Annual Confirmation

Persons claiming an exemption under Regulation 4.5 or Regulation 4.13(a)(3) are required to file a notice of such claim with the NFA for each fund as to which the exemption is claimed. Both rules also require persons claiming the exemption to amend the notice if it becomes inaccurate and to withdraw the claim altogether if the person no longer meets the eligibility requirements.

The 2012 amendments also added an annual confirmation requirement for both rules. Many dual registrants have dozens or even hundreds of funds for which they claim these exemptions. Annual confirmation imposes a substantial burden without adding any regulatory benefit. Filers whose exemption status changes, in that they can no longer rely on the exemption, are required to make a filing to update their status. Thus, it can reasonably be assumed by regulators and industry participants alike that the status indicated by the filing is accurate unless updated.

In adding the annual confirmation requirement, the Commission did not cite evidence of "stale" filings or indications that ineligible persons were relying on the exemptions. The reason given for the change was rather to promote improved transparency regarding the number of entities

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[24] *See* SEC Derivatives Disclosure Guidance, *supra* note 23.

either exempt or excluded from the Commission's registration and compliance programs.[25] In fact, annual confirmation does not increase transparency. On the NFA's BASIC website, which is easily accessed on a public basis, a person's exempt status is clearly visible with or without annual confirmation. Accordingly, the substantial burdens involved in making numerous annual filings, which do not change the information already on record and available to both the Commission and the public, do not serve the intended purpose.[26]

f. Absence of Harmonization of Requirements for Dual Registrants

Subjecting SEC registrants to the Commission's CPO and CTA regulation creates a system of dual regulation that is excessive relative to any incremental benefits to investors or the markets.

RICs and RIAs are already subject to extensive regulation by the SEC, an agency whose historic mission has focused on the protection of investors, under a comprehensive regulatory regime that includes the '40 Act, the Investment Advisers Act of 1940 ("Advisers Act"), the Securities Act of 1933 ("Securities Act"), and the Securities Exchange Act of 1934. The protections afforded under these laws include, among others depending on the entity: antifraud prohibitions; comprehensive disclosure to investors that describes the fees and expenses they will pay; the applicable investment objectives and strategies; and risks of investing; protection of customer assets; disclosure and mitigation of potential conflicts of interest; restrictions on affiliate transactions; codes of ethics; compliance programs; recordkeeping; regulatory reporting; limits on the use of leverage; and independent board oversight.

While the Commission has addressed some areas of duplicative regulation through the RIC harmonization rules, true harmonization designed to avoid unnecessary and duplicative regulation would require a regime of substituted compliance, where the Commission would recognize the RIA's and RIC's compliance with SEC regulation as compliance with the CPO and CTA regulation as well. Short of full substituted compliance, several areas stand out as especially strong candidates for further harmonization.

Recordkeeping. RIAs that must register with the Commission as CPOs or CTAs, as well as the RICs and private funds they advise, are subject to the full set of CPO and CTA recordkeeping requirements. Notwithstanding that SEC registrants already comply with the SEC's comprehensive recordkeeping requirements, CPO or CTA registration requires that they also consult and comply

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25 Regulation 4.5 2012 Adopting Release, *supra* note 9, at 11,265.

26 As an additional reason for the new requirement, the Commission also stated its belief that an annual notice requirement would enable the Commission to determine whether exemptions and exclusions should be modified, repealed, or maintained as part of the Commission's ongoing assessment of its regulatory scheme. Again, since the filer's continuing status is evident from the NFA's website, it is hard to see how annual confirmation provides additional information to the Commission.

with an entirely separate set of recordkeeping rules. While the purposes overlap, there are, naturally, some differences, which create an entirely unnecessary duplication of effort.[27]

Regulatory reporting. RIAs subject to the Commission's registration requirements must comply with the CFTC's and NFA's complex and burdensome regulatory reporting regime, including quarterly or annual filing of CFTC Form CPO-PQR (depending on the size of the adviser), quarterly filing of NFA Form PQR, and annual/quarterly filing of analogous forms required for CTAs (Form CTA-PR annually and NFA Form PR quarterly). These forms, while designed to serve the same regulatory oversight goal sought by the SEC in its reporting forms, require different formats and reporting styles, resulting in labor intensive dual reporting. The burdens of CFTC regulatory reporting on RIAs and RICs can be expected to be both magnified, and the benefits greatly reduced, by the SEC's comprehensive new reporting requirements on Form N-PORT, Form N-CEN, and Form ADV, which were adopted by the Commission last year and which have phased in compliance dates, starting on Oct. 1, 2017 for Form ADV and on June 1, 2018 for Form N-PORT.[28] To the extent that the Commission believes additional reporting of some type on its Forms is necessary, we would welcome the opportunity to work with the staff on identifying and modifying parts of the current forms that impose the greatest burdens without providing information of commensurate regulatory value.

NFA Rules. RIAs that are required to register as CPOs or CTAs must comply with an additional comprehensive set of NFA rules and filing requirements. These add yet another regulatory overlay, in this case with variations designed historically for an entirely different set of markets and market participants.

2. Lack of Interpretive Guidance for Section 4m(3)

a. Background

Section 4m(3) of the CEA is designed to avoid unnecessary and duplicative dual regulation by the Commission of asset managers that are already regulated as investment advisers by the SEC under the Advisers Act. It was initially enacted by Congress in 2000 as part of the Commodity

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27 It is also important to note that with respect to market transactions within its jurisdiction, the Commission now has enhanced recordkeeping and reporting requirements that apply to market participants generally, whether or not they are registered as CPOs or CTAs (*see, e.g.*, Part 45 of the Commission's regulations and the large trader reporting requirements).

28 *See* Investment Company Reporting Modernization, 81 Fed. Reg. 81,870 (Nov. 18, 2016). Private fund adviser CPOs are also required to file Form PF, which imposes additional duplicative burdens. There is partial substituted compliance permitted for portions of Form CPO-PQR with respect to Form PF filers, but it is not complete, and NFA Form PQR does not permit substituted compliance.

Futures Modernization Act, together with a companion provision in the Advisers Act, which provided a "mirror" exemption from SEC Advisers Act registration for CFTC-registered CTAs.[29]

Section 4m(3) of the CEA is a statutory exemption from CTA registration specifically designed for RIAs. To qualify for the exemption, in addition to being registered with the SEC under the Advisers Act, the RIA must meet two tests designed to ensure that the RIA is not primarily a CTA. First, the RIA's business may not consist primarily of acting as a commodity trading advisor (the "overall business condition"). Second, the RIA may not act as a commodity trading advisor to any commodity pool that is engaged primarily in trading commodity interests (the "commodity pool condition").[30]

Both the CEA and the Advisers Act exemptions were subsequently amended as part of the Dodd-Frank Act in connection with relevant terminology and changes elsewhere in the Act. Section 4m(3) was also amended to add a paragraph to the effect that "engaged primarily" includes holding oneself out as being so engaged. For purposes of the exemption:

> [A] commodity trading advisor or a commodity pool shall be considered to be "engaged primarily" in the business of being a commodity trading advisor or commodity pool if it is or holds itself out to the public as being engaged primarily, or proposes to engage primarily, in the business of advising on commodity interests or investing, reinvesting, owning, holding, or trading in commodity interests, respectively.[31]

The Dodd-Frank Act also added a new definition of the term commodity interest for use in connection with the Section 4m(3) exemption, which is discussed below. The Advisers Act mirror provision was amended to add a provision exempting advisers that are CFTC-registered CTAs and advise private funds, unless the adviser's business is predominately the provision of securities-related advice.

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29 The Advisers Act exemption adopted in 2000 was then codified as Section 203(b)(6)(A) and (B) of the Advisers Act.

30 The Advisers Act mirror exemption provided an exemption from SEC registration as an investment adviser for CFTC-registered CTAs whose business does not consist primarily of acting as an investment adviser and that do not act as an investment adviser to a RIC or a company that has elected to be regulated as a business development company under section 54 of the '40 Act (business development companies are companies that would otherwise qualify as investment companies and be required to register under the '40 Act but, because of the nature of their business, may elect a simplified regulatory regime under the '40 Act).

31 *See* Commodity Exchange Act § 4m(3)(B).

Taken together, both in their original form and as amended by the Dodd-Frank Act, these mirror exemptions demonstrate a Congressional goal of avoiding dual CFTC and SEC regulation by assigning the regulation of asset managers that may be both RIAs and CTAs to the regulator of the manager's primary activity.

b. Burdens and Inefficiencies Due to Lack of Interpretative Guidance

Three fact patterns have emerged where interpretive guidance would help ensure that Section 4m(3) serves the legislative purpose of eliminating the need for Commission regulation of RIAs that are not primarily engaged as CTAs either to pools or to their clients overall and do not hold themselves out at such.

First, interpretive guidance would clarify that registration is not required for CTA advice provided by an RIA to a fund portfolio that is not engaged primarily in commodity interest trading. RIAs often are retained by funds to provide advice to a discrete portion of a fund's assets (sometimes called a sleeve or portfolio of the fund). This practice is common for funds that focus on multiple investment strategies, and is beneficial to investors by permitting diversification within a single fund while maximizing the expertise for different components within the diversified strategy.

In these situations, the fund's operator or adviser may seek to retain, for one of the multiple strategy portfolios within the fund, an RIA that provides securities advice with an incidental or *de minimis* commodity interest component relative to the securities advice, or a level of commodity interest trading that is otherwise properly characterized as not a primary component of the RIA's trading strategy. Such an RIA would comfortably qualify for the overall Section 4m(3) requirement that its business must not be primarily a commodity interest trading business. Moreover, the RIA would not be providing commodity trading advice to a portfolio that is or holds itself out as being engaged primarily in commodity trading.

In some cases, despite the limited nature of the RIA's commodity interest trading for the fund, the fund as a whole, counting the strategies for which the RIA has no responsibility or association of any type, may be engaged primarily in commodity interest trading. Section 4m(3) does not expressly address the situation where an RIA provides advice to a primarily securities-based sleeve of a fund. Rather, the statutory language focuses on the fund as a whole and requires as a condition to the exemption that the RIA "does not act as a commodity trading advisor to any commodity pool that is engaged primarily in trading commodity interests." Thus, Section 4m(3) could be viewed as not available to the RIA providing securities advice to the fund, with commodity interest trading solely as a non-primary component (even at incidental or *de minimis* levels) simply because the rest of the fund might be viewed as engaged primarily in trading commodity interests.[32]

It would defeat the purpose of Section 4m(3) if an RIA that is not engaged primarily as a CTA overall, limits its commodity trading advice to the fund to a level below "primarily," and does not hold either itself or the managed portfolio out as engaged primarily in commodity trading, were nonetheless denied the exemption and required to register with the Commission as a CTA. If Section 4m(3) were read narrowly in this manner, such a reading would jeopardize the ability of an RIA relying on the Section 4m(3) exemption to advise multi-strategy funds, and thus limit the universe of RIAs available for these funds and their investors, all without serving any meaningful regulatory goal.

As a compliance matter, it makes far more regulatory sense that asset managers responsible for only a portion of a fund's assets should be required to look only to the assets and strategies they are providing in order to determine their own CTA status. Indeed, it would be both unfair and unworkable to require managers to take into account the trading strategies and positions of other managers, since they have no ability to access this information, and certainly no ability to control the trading of other managers.[33] An asset manager's exemptive status under Section 4m(3) should be determined by its own activities, not those for which it has no knowledge or control.

Second, interpretive guidance would help clarify that registration is not required for offshore fund and offshore client CTA activities. In a global organization, a non-U.S. entity may for various reasons wish to register with the SEC under the Advisers Act, and provide investment advice to certain types of U.S. clients. Such a non-U.S. RIA that provides commodity interest trading advice on a limited basis (below the "engaged primarily" level) may rely on Section 4m(3) like any other RIA. As a non-U.S. entity, the RIA may also sponsor or advise offshore funds that are offered and sold only to non-U.S. investors, including funds that may be considered engaged primarily in trading commodity interests or that qualify as commodity pools within the meaning of the applicable local regulatory regime.

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32 We are not requesting guidance on the meaning of engaged "primarily" in Section 4m(3). The staff has wisely declined to provide such guidance, and we support the continuation of this policy. *See* CFTC Letter No. 09-27 at n.5 (June 25, 2009).

33 Where RICs are structured as multi-manager funds, with a number of different unaffiliated sub-advisers responsible for managing different portfolios or sleeves within the fund, the advisory agreements of the sub-advisers generally prohibit them from consulting with each other concerning transactions for the fund in securities or other assets in order to comply with SEC Rule 17a-10. Rule 17a-10 provides an exemption from the affiliated transaction provisions of section 17(a) of the '40 Act for certain sub-advisory affiliates.

The "commodity pool" prong of Section 4m(3) creates potential uncertainty in this scenario. There would be no regulatory purpose served by requiring a non-U.S. RIA to register as a CTA with the Commission based on its activities in advising a non-U.S. fund, from a non-U.S. location, where the fund is offered and sold only to non-U.S. investors.[34] However, the term commodity pool, *per se*, does not specify that it refers only to U.S. commodity pools. To a lesser extent, there may also be uncertainty about the ability of a non-U.S. RIA to rely on Section 4m(3) with respect to non-U.S. clients that are not pools (this would be the case if the non-U.S. clients were counted in assessing the overall mix of the RIA's business). An offshore RIA's advice to non-U.S. clients also poses no regulatory concern for the Commission, and should not be considered in determining the need for CTA registration, yet there is no express guidance under Section 4m(3) that addresses this issue.[35]

These regulatory uncertainties can result in either inefficient organizational structuring or over-regulation by the Commission of activities in which it has no regulatory interest. With respect to the RIA's non-U.S. funds and clients, the RIA's non-U.S. activities would be regulated in accordance with applicable local regulations and non-U.S. investors would be protected in accordance with those regulations. In most relevant jurisdictions, these local protections have been or are in the process of being enhanced pursuant to increasingly heightened global regulatory standards in recent years. To the extent the non-U.S. funds or clients trade commodity interests in the U.S. markets, those market activities would be subject to the Commission's now extensive regulations applicable to all market participants that have been put in place in the years following the financial crisis of 2008 and the Dodd-Frank Act.

Accordingly, denying non-U.S. RIAs the ability to rely on Section 4m(3) based on their non-U.S. CTA activities, and imposing the Commission's and NFA's regulatory regime on these entities for non-U.S. activities, would impose significant burdens both on the RIAs and the regulators,

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[34] The Commission has recognized the principle of counting only U.S. activities in determining the availability of CTA exemptions in Regulation 4.14(a)(10), which clarifies that non-U.S. clients need not be counted in determining whether a non-U.S. CTA has fifteen or fewer clients for purposes of the exemption provided by Section 4m(1) of the CEA. More generally, the Commission has recognized the absence of U.S. regulatory interest in non-U.S. advisers to non-U.S. funds (funds that are not offered or sold to U.S. persons) by providing an exemption for offshore CTA activities provided to such funds, subject to certain conditions on their trading in U.S. markets (see Regulation 3.10(c)(3)(i)). Concerns about overly narrow interpretations of Regulation 3.10(c), as well as cross border CPO and CTA regulation more generally, are addressed below in Part III. For purposes of Section 4m(3), the request is that however Regulation 3.10(c) is interpreted, the offshore activities that would be exempt under Regulation 3.10(c) should not jeopardize an offshore adviser's ability to rely on Section 4m(3). Section 4m(3) should not be interpreted in a manner that results in "back door" U.S. regulation of offshore activities already determined to be outside of U.S. regulatory interests.

[35] As discussed above, Regulation 4.14(a)(10) expressly excludes offshore clients of offshore advisers from the fifteen client limit. In addition, Regulation 3.10(c)(3)(ii) provides an exemption for offshore CTA advice to non-pool, non-U.S. clients as well as offshore pools, which supports avoiding "back door" regulation of these activities through an overly narrow reading of Section 4m(3).

without increasing investor protection, market surveillance, or any other legitimate U.S. regulatory goal.[36]

Third, interpretive guidance should clarify the scope of commodity interests to be considered under Section 4m(3). As discussed above, the Dodd-Frank Act expanded the definition of commodity interests in the CEA to include swaps, among other financial instruments not previously within the Commission's jurisdiction. However, with respect to a limited category of foreign exchange instruments referred to as "deliverable" foreign exchange forwards and swaps, the Secretary of the U.S. Department of the Treasury ("Treasury") has issued a determination, pursuant to express authority granted in the CEA, that exempts these instruments from the definition of "swap."[37] The Secretary of the Treasury made this determination on Nov. 16, 2012, and thus these deliverable foreign exchange forwards and swaps are not commodity interests under the CEA.

As part of the Dodd-Frank Act, a separate definition of commodity interest was added to Section 4m(3):

> For purposes of this paragraph, commodity interests shall include contracts of sale of a commodity for future delivery, options on such contracts, security futures, swaps, leverage contracts, **foreign exchange**, spot and forward contracts on physical commodities, and any monies held in an account used for trading commodity interests (emphasis added).[38]

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36 The approach we recommend under Section 4m(3) has been adopted by the SEC in an interpretation known as the Touche Remnant doctrine. Under this doctrine, in determining whether a foreign fund meets certain threshold requirements that would cause it to be an "investment company" subject to regulation under the '40 Act, only investments by U.S. persons will be considered. *See* Goodwin, Procter & Hoar, SEC No-Action Letter (Feb. 28, 1997), https://www.sec.gov/divisions/investment/noaction/1997/goodwinprocterhoar022897.pdf; Touche, Remnant & Co., SEC No-Action Letter (Aug. 27, 1984).

37 Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, 77 Fed. Reg. 69,694 (Nov. 20, 2012). A foreign exchange forward is defined in Section 1a(24) of the CEA as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange." A foreign exchange swap is defined in Section 1a(25) of the CEA as "a transaction that solely involves (A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (B) a reverse exchange of the 2 currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange." Section 1a(47)(E) of the CEA provides that these instruments shall not be considered swaps, other than for limited reporting, business conduct, and antifraud purposes if the Secretary of the Treasury so determines in accordance with Section 1b of the CEA.

38 *See* Commodity Exchange Act § 4m(3)(C).

In some respects, this definition is broader than the general post-Dodd-Frank commodity interest definition, in that it includes spot and forward contracts on physical commodities and monies held in an account used for commodity trading interests. This last component would require counting the entirety of a futures account with a futures commission merchant ("FCM"), including cash held as margin, not just the open contracts. In addition, the Section 4m(3) definition would include spot and forward contracts on physical commodities, which would not ordinarily be considered commodity interests. It is understandable that Congress may have wished to include these activities as commodity interest trading activities for purposes of determining an adviser or fund's primary business, and neither of them is likely to have a significant impact on most RIAs.

The language in the Section 4m(3) definition that does raise an interpretive issue is the reference to "foreign exchange." That is not a defined term, or one that has a common understanding, and thus causes confusion and inconsistency in interpreting Section 4m(3). We believe it must refer either to retail foreign exchange or non-deliverable foreign exchange instruments and cannot reasonably be interpreted to include the deliverable foreign exchange forwards and swaps that the Secretary of the Treasury determined to exempt from the swap definition, in accordance with the express provisions of the CEA. Interpreting the vague term "foreign exchange" to include those instruments would undermine both the Treasury's determination and the goal of the CEA with respect to these instruments. More generally, it would require RIAs that use these instruments either to cease using them (to the detriment of their clients) or to undertake the substantial regulatory burdens of CTA registration in order to provide advice on instruments that do not warrant such regulation.

Interpreting the term "foreign exchange" in Section 4m(3) to refer to retail forex and non-deliverable forwards, but not foreign exchange forwards and swaps exempted under the Treasury determination, is also supported by the position taken in a staff no-action letter relating to these instruments.

In the fall of 2012, during the time period when the Treasury had proposed to make the determination but had not taken final action, there was uncertainty among asset managers (and others) as to how deliverable foreign exchange instruments should be treated pending final action. To address this uncertainty, the staff issued a no-action letter providing time limited relief that effectively would protect operators and advisers from failure to register based on deliverable foreign exchange instruments during the time period before the Treasury issued its final determination:

> Accordingly, the Division will not recommend enforcement action to the Commission against a person who operates a collective investment vehicle that trades foreign exchange swaps and forwards or a person who provides advice concerning foreign exchange swaps and forwards, and would have to apply to be registered with the Commission as a commodity pool operator or commodity trading

> advisor solely as a result of these respective activities, for failure to apply to be registered with the Commission, if the Secretary issues a final determination to exempt foreign exchange swaps and forwards from the term "swap" that becomes effective before December 31, 2012.[39]

Among other things, this no-action relief made clear the staff's view that the Treasury determination to exempt these instruments from the swap definition would mean that they were not commodity interests for purposes of CPO and CTA registration. There is no reason that this interpretation should not apply to a registration determination based on Section 4m(3).

3. Additional Issues for SEC-Registered Asset Managers

While we have identified above a number of important areas where we believe the Commission's regulation of SEC-registered asset managers could be streamlined for the benefit of investors and the markets, we have by no means provided an exhaustive list of instances of over-regulation asset managers have experienced. Additional areas that have created unnecessary regulatory friction include delegation of CPO authority, treatment of insulated series or portfolios of private funds, and the Commission's post-2012 consideration of controlled foreign corporation subsidiaries of RICs as separate commodity pools. We hope that the KISS project will be an ongoing process during which we can work constructively with the staff to resolve and simplify regulation in these and other areas.

C. Recommendations

AMG recommends that the Commission:

1. Expand the CPO exemptions for SEC registrants to avoid creating an overly broad universe of Commission registrants by either:

    a. Restoring the pre-2012 exemptions, including:

        (i) Eliminating the trading and marketing tests in Regulation 4.5 for RICs; and

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[39] CFTC No-Action Letter No. 12-21 (October 12, 2012) (Time Limited No-action Relief: Foreign Exchange Swaps and Foreign Exchange Forwards Not to be Considered in Calculating Aggregate Gross Notional Amount for Purposes of Swap Dealer De Minimis Exception or in Calculating Substantial Position in Swaps or Substantial Counterparty Exposure for Purposes of the Major Swap Participant Definition; Time-Limited No-Action Relief for Persons that Meet the Definitions of Commodity Pool Operators and Commodity Trading Advisors Solely as a Result of Their Foreign Exchange Swap and Foreign Exchange Forward Activities).

(ii) Restoring the private fund CPO exemption in Regulation 4.13(a)(4) for RIAs and their affiliates;

b. Or, alternatively, reducing unnecessary "over registration" under Regulation 4.5 and Regulation 4.13(a)(3) through appropriately tailored interpretation of conditions in current Regulation 4.5 and Regulation 4.13(a)(3), including:

(i) Excluding bona fide hedging, as defined under appropriate current Commission standards, from the *de minimis* trading test calculation;

(ii) Permitting netting of uncleared swaps positions to determine *de minimis* exposure;

(iii) Clarifying the marketing test factors to avoid the "chilling effect" of vague, subjective factors and resulting over registration.

c. Eliminating the annual confirmation requirement under Regulation 4.5 and Regulation 4.13(a)(3).

2. Harmonize Commission regulation of dual registrants with existing SEC regulation by permitting substituted compliance for SEC registrants by:

a. Eliminating duplicative CPO reporting, including:

(i) For RICs, eliminate Form CPO-PQR and NFA Form PQR reporting requirements for SEC-registered advisers to registered funds that currently file SEC Forms N-Q, N-CSR, and N-SAR, and that will be required to comply with the SEC's enhanced and modernized reporting requirements.

(ii) For private funds, eliminate Form CPO-PQR and NFA Form PQR reporting requirements for SEC-registered advisers that file Form ADV and Form PF.

b. Eliminating duplicative CTA reporting, including Form CTA-PR and NFA Form PR reporting requirements for SEC-registered advisers that file Form ADV.

c. Eliminating differing recordkeeping requirements by accepting as substituted compliance by SEC-registered advisers applicable

Advisers Act and '40 Act recordkeeping requirements for all Commission CPO and CTA recordkeeping requirements.

3. Rationalize and harmonize interpretation of the statutory CTA exemption for SEC-registered investment advisers in Section 4m(3) of the CEA by:

   a. For advice to portfolios within a pool, clarifying that an SEC-registered adviser to a portfolio within a pool may look only to assets in the portfolio in determining whether the RIA is providing advice to a pool that is engaged primarily in commodity interest trading.

   b. For advice to offshore pools and offshore clients, clarifying that advice to an offshore pool (that does not market or offer shares in the U.S. or to U.S. persons) or offshore clients is not counted for purposes of Section 4m(3).

   c. Clarifying that treatment of "foreign exchange" as commodity interests for purposes of Section 4m(3) does not include foreign exchange instruments that are exempt from the definition of swaps under the CEA pursuant to the Treasury determination.

4. Engage with asset managers on additional areas that have created unnecessary regulatory friction, including delegation of CPO authority, treatment of insulated series or portfolios of private funds, and the Commission's post 2012 consideration of controlled foreign corporation subsidiaries of RICs as separate commodity pools.

II. <u>CPO and CTA Registration and Regulation</u>: Reduce Overly-Broad Regulation and Inefficient Use of Commission Resources by Interpreting "Commodity Pool" Consistent with the Statutory Definition and Purpose

A. Commission's Regulatory Goals

Since the adoption of the Dodd-Frank Act, which amended the CEA to include references to the term "commodity pool" in a broad range of provisions and expanded the term commodity interest to include swaps and other financial instruments, the Commission and staff have been called on repeatedly and in many contexts to interpret the term "commodity pool." The Commission has stated its intent to employ a plain language reading of statutory terms that, in accordance with the tenets of statutory interpretation, is consistent with the terms of the statute, the legislative purpose, and judicial precedents.[40] The Commission also seeks to make efficient use of its staff resources and maximize the value of tax dollars spent in pursuing the Commission's mission.[41]

B. Excessive Regulatory Burdens and Adverse Impacts

1. History of "Single Commodity Interest" Position and *Ad Hoc* Interpretive Process

As amended by the Dodd-Frank Act, the CEA defines the term "commodity pool" to mean "any investment trust, syndicate, or similar form of enterprise **operated for the purpose of trading in commodity interests**. . ." (emphasis supplied).[42] The term commodity interests includes futures, swaps, and commodity options, among other instruments enumerated in the commodity pool definition.

The Commission and its staff have interpreted the term commodity pool to include any pooled vehicle that holds a single swap for any reason, absent a specific Commission or staff determination to the contrary.[43] This approach (1) is inconsistent with the terms of the statutory definition, which requires the pool to be operated for the purpose of trading in commodity interests; (2) results in the over inclusion of many types of entities that are clearly not intended, or understood by investors, to be commodity pools; (3) requires the expenditure of unnecessary staff resources and creates a regulatory bottleneck in order to provide "not a commodity pool" guidance in each specific case, together with interim uncertainty pending staff action; and (4) leads to numerous follow-on adverse consequences and areas of uncertainty (*e.g.*, whether ownership of certain entities creates a

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40 *See, e.g.,* Regulation 4.5 2012 Adopting Release, *supra* note 9, at 11,262; End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560, 42,564 (July 19, 2012) ("The Commission believes that the captive finance company exception must be interpreted in a manner consistent with the plain language of the statute.").

41 *See, e.g.*, CFTC, PRESIDENT'S BUDGET FISCAL YEAR 2016 (2015), *available at* http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/cftcbudget2016.pdf ("The Commission is focused on maintaining effective management and administrative programs as efficiently as possible to maximize the resources and staff available to the primary mission activities.").

42 Section 1a(10)(A) of the CEA. Section 1a(10)(B) provides that the Commission, by rule or regulation, may include within, or exclude from, the term "commodity pool" any investment trust, syndicate, or similar form of enterprise if the Commission determines that the rule or regulation will effectuate the purposes of this chapter.

43 *See* Regulation 4.5 2012 Adopting Release, *supra* note 9, at 11,263 ("As a result, one swap contract would be enough to trigger the registration requirement.").

"fund of funds" commodity pool and the regulatory status of service providers to "inadvertent commodity pools" as potential CPOs or CTAs).[44]

Historically, the CEA did not include a definition of commodity pool. As a general matter, the CEA does not regulate commodity pools, as such, but rather regulates the persons that provide services to commodity pools, in particular CPOs and CTAs. Definitions of CPO and CTA were added to the CEA in 1974 as part of the Commodity Futures Trading Commission Act, which provided for the registration and regulation of CPOs and CTAs by the newly established Commission.[45] These definitions referred to commodity pools indirectly, but a statutory definition of "commodity pool" itself was not considered necessary to the regulatory scheme.

The Commission's Part 4 Regulations, on the other hand, have included a definition of "pool" since 1979. That definition was introduced in connection with the adoption of disclosure rules that used the term "pool" in a number of disclosure items. The original Part 4 "pool" definition, adopted as Regulation 4.10(d), was extremely broad and open ended. Original Regulation 4.10(d) defined the term pool as "any investment trust, syndicate or similar form of enterprise **that trades commodity interests**" (emphasis supplied), which at the time meant primarily futures contracts and commodity options.

In 1980, the Commission recognized the overbreadth of the original "that trades commodity interests" definition of the term pool and proposed a narrower replacement definition that introduced a "purpose" test: "any investment trust, syndicate or similar form of enterprise **operated for the purpose of trading in commodity interests**" (emphasis supplied). In the proposal, the Commission explained that by "specifying that a pool is an entity operated for the purpose of trading commodity interests," the revised definition would "serve to exclude more persons from the term 'commodity pool operator,' and consequently from registration as a CPO."[46]

In 1981, the Commission adopted the narrower "purpose" driven definition of "pool" as proposed.[47] All of the commenters had supported the Commission's objective of clarifying the

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44 Outside of the CPO/CTA area, questions have also arisen as to the commodity pool status of market participants for purposes of Title VII of Dodd-Frank, and how to answer "commodity pool" questions on Dodd-Frank related protocols and other documentation. The principles-based definition we recommend would also be helpful in streamlining those processes.

45 Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, § 202, 88 Stat. 1389, 1395-96 (1970).

46 Revisions of Commodity Pool Operator and Commodity Trading Advisor Regulations; Proposed Rules, 45 Fed. Reg., 51,600, 51,601 (Aug. 4, 1980).

47 Revisions of Commodity Pool Operator and Commodity Trading Advisor Regulations; Delegation of Authority, 46 Fed. Reg. 26,004 (May 8, 1981).

scope of the term, and had suggested further steps to narrow the definition in light of that goal. These suggestions included a numerical threshold (*e.g.,* 10%) of assets committed to commodity interest trading, below which the entity would not be considered a pool, and a "principal purpose" test. The Commission declined to adopt these suggestions, which it thought went too far in the other direction for various reasons. The "operated for the purpose" test therefore constituted a balanced, middle ground between the original "that trades" test, which the Commission recognized as overly broad, and the narrower bright-line tests proposed by the commenters.

In adopting the purpose test, the Commission stated that whether an entity may or may not be a pool within the scope of the rule "depends on an evaluation of all the facts relevant to the entity's operation." The Commission noted that the staff had in the past issued interpretations of Regulation 4.10(d), as well as other Part 4 Regulations, and invited interested persons to seek such staff interpretations. This approach, which declined to provide principles for entities to apply the definition on their own, gave rise to an *ad hoc* process where the staff provided case-by-case relief in the form of no-action or interpretative letters to persons writing in and describing their facts and circumstances.[48]

The current statutory definition of commodity pool added by the Dodd-Frank Act follows the narrowed, purpose-oriented definition adopted in Part 4 in 1981. Section 1a(10) of the CEA now defines "commodity pool" as "any investment trust, syndicate, or similar form of enterprise **operated for the purpose of trading in commodity interests**" (emphasis supplied), which includes all futures, swaps, commodity options, retail forex and commodity transactions, and leverage transactions.[49]

2. Current Interpretation of "Commodity Pool" Extends Beyond Statutory Purpose and Definition

Following the Dodd-Frank expansion of the term commodity interest, it soon became clear that without guidance on the "operated for the purpose" component of the new statutory definition, a virtually limitless universe of financial vehicles could be considered commodity pools, and whose sponsors could thus be considered CPOs. As a result, the Commission and staff were called upon

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48 This gave rise to a series of interpretive letters referred to as the "not a pool" letters, the parameters of which were later, to some extent, incorporated into the original version of Regulation 4.5. For a discussion of the pre-Regulation 4.5 *ad hoc* "not a pool" interpretive process, see Jeffrey S. Rosen, Regulation of Commodity Pool Operators under the Commodity Exchange Act, 40 Wash. & Lee Law Rev. 937, 961 (1983).

49 This definition of pool corresponds to the reference to commodity pools incorporated in the statutory definition of commodity pool operator, which also has a "purpose" test. The term commodity pool operator is defined in Section 1a(11) of the CEA to include any person that is "[e]ngaged in a business that is of the nature of a commodity pool" and "who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests. . ."

in a range of circumstances to provide interpretive guidance or no-action relief that would give meaning to the critical phrase "operated for the purpose."

It also became clear that continuation of the *ad hoc* process and "single commodity interest" approach, which had originated at a time when there was no statutory definition and the term commodity interests was far more limited, would create massive resource and bottleneck issues for both market participants and the staff, as well as significant regulatory uncertainty for the industry as entities that were considered "guilty until found innocent" with respect to commodity pool status were forced to wait in long lines to get their answer.

Nonetheless, the staff adhered to the old *ad hoc* procedure and entities seeking guidance were required to present their case to the staff. Moreover, in responding to these requests, the staff took the broadest possible view of the meaning of "operated for the purpose." This increased both the level of uncertainty and the number of entities that would need the staff's case-by-case facts and circumstances decision. Even in cases that seemed to present generic situations, where no-action or interpretive relief could appropriately be principles based and relied on by others—a result that would save both the industry and staff the time and resources used in the case-by-case process—the staff imposed fact specific conditions that prevented principles-based reliance on the letters.

The current approach to interpreting the term commodity pool thus imposes excessive regulatory burdens from both a substantive and procedural point of view. The overbroad interpretation of "operated for the purpose" results in a CPO and CTA registration requirement for many more market participants than is justified by the statutory definition, as well as uncertainty for all market participants trying to determine whether the registration requirement applies to them.[50] From a procedural standpoint, the case-by-case approach, where any vehicle trading commodity interests could be presumed to be "operated for the purpose" until the Commission or staff says otherwise, has proven unworkable for market participants and resulted in wasteful expenditures of the Commission's scarce resources.

The practice of seeking staff interpretations to define the term "commodity pool" in every different fact pattern may have seemed sensible in the past, when the definition applied to far fewer entities given the limited definition of commodity interest. Also, given that Dodd-Frank posed a complex set of new legal and policy challenges, it is understandable that the staff initially chose to proceed cautiously and extend the Commission's potential jurisdiction to the greatest extent.

Seven years later, however, the ill effects of that expansive reading have been demonstrated, and the Commission has gained enough experience to develop a more functional test that reduces

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50 An overly expansive interpretation of the purpose test in the definition of commodity pool necessarily expands the category of persons swept in by the term "commodity pool operator," which uses the same test (*see supra* note 49).

unnecessary burdens on both the industry and the Commission's staff. The KISS initiative provides an opportunity to bring up to date both the process and principles for determining whether an entity is a commodity pool in the context of CPO and CTA regulation. What is needed now is a principles-based approach for determining commodity pool status that market participants can apply on their own in a reasonable fashion to obtain reasonable certainty as to their status, without the need for a case-by-case staff response.

3. Support for a Principles-Based Approach

There are a number of judicial and regulatory precedents that provide support for developing a principles-based approach to the definition of commodity pool.

The *Lopez* Factors. The seminal judicial precedent for interpreting the term "commodity pool" is considered to be *Lopez v. Dean Witter* ("*Lopez*"), in which the Court held that a futures trading account was not a commodity pool, and thus Dean Witter was not a CPO, based on consideration of four factors.[51] The test formulated in the *Lopez* case for determining when a vehicle is a commodity pool under the CEA, and thus whether its operator is a CPO, functions in much the same fashion as the so-called "*Howey* test" used under the federal securities laws for determining whether an instrument is an "investment contract" and thus a security.[52]

The four factors that the *Lopez* Court identified as required to be present in a commodity pool are:

> (1) an investment organization in which the funds of various investors are solicited and combined into a single account **for the purpose of investing in commodity futures contracts**;
>
> (2) common funds used to execute transactions on behalf of the entire account;
>
> (3) participants share pro rata in accrued profits or losses from the commodity futures trading; and
>
> (4) the transactions are traded by a commodity pool operator in the name of the pool rather than in the name of any individual investor.[53]

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51 *Lopez v. Dean Witter Reynolds, Inc. ("Lopez")*, 805 F.2d 880 (9th Cir. 1986).

52 *See SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

53 *Lopez, supra* note 51, at 884 (emphasis added).

Lopez was decided at a time when the CEA did not include a definition of commodity pool, and, under the facts of the case, the issue raised related to the "pooling" component of the factors rather than the purpose component (the purpose of the account in question was clearly to trade futures).[54] Still, the *Lopez* factors, which clearly require both a purpose and a pooling component, are commonly cited as foundational for making the commodity pool determination and should be considered in developing a principles-based approach.[55]

Analogy to SEC Precedents. The question of commodity pool status has also arisen in connection with determining whether commodity pools should be considered investment companies under the '40 Act and thus regulated as such by the SEC.

The term "investment company" as defined in the '40 Act includes both a primary business, or "holding out," test and a quantitative asset-based test. Section 3(a)(1)(A) of the '40 Act defines the term "investment company" to include any issuer that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." Section 3(a)(1)(C) defines the term "investment company" also to include any issuer which is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and holds or proposes to acquire investment securities with a value of more than 40% of the issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. Finally, Section 3(b)(1) of the '40 Act provides an exception from the asset-based definition of investment company (Section 3(a)(1)(C)) for any issuer that is primarily engaged in a business or businesses other than investing, reinvesting, owning, holding or trading in securities, either directly or through wholly-owned subsidiaries.

Many commodity pools that are held out to the public as such may also meet the asset-based definition of investment company in Section 3(a)(1)(C), in view of the nature of their business. Accordingly, it has been critical to determine under what circumstances these commodity pools qualify for the Section 3(b)(1) exception from the asset-based test as a result of their being "primarily engaged" in a non-securities business, in particular the business of operating a commodity pool. Historically, the SEC has developed a principles-based list of factors for making the Section 3(b)(1) determination, which issuers may use on a self-executing basis to determine their investment

54 The Court said that few courts had specifically attempted to define what constitutes a commodity pool and that the CEA "fails to provide any assistance in this regard."

55 The staff has stated in a number of commodity pool letters that it does not view the *Lopez* factors as determinative. However, in these letters the staff does not appear to specifically disagree with the factors or their application to the facts presented, but rather wishes to adhere to the case-by-case process where the staff, not the market participant, makes the decision.

company status (these are referred to as the Tonopah Mining factors, after the case in which they were first articulated).[56]

In 1996, the SEC staff developed a specialized list of the Tonopah Mining factors for application in the commodity pool area. This was in response to a request from the Managed Futures Association ("MFA") for no-action relief under the '40 Act to permit certain commodity pools to invest some or all of their assets in interests of other commodity pools (second tier pools) without registering the top tier pools as investment companies under the '40 Act.[57] The MFA stated that the relief would permit a structure that provided substantial benefits to investors and was necessary because registration under and compliance with the '40 Act were impractical for most commodity pools, as there are numerous provisions of the '40 Act that are fundamentally inconsistent with the operation of a typical commodity pool.

In its response, the SEC staff granted the requested relief and stated that in its view, a commodity pool's primary business should be deemed to be investing or trading in commodity interests if:

> (1) the pool looks primarily to commodity interests as its principal intended source of gains;
>
> (2) the pool anticipates that commodity interests present the primary risk of loss; and
>
> (3) the pool's historical development, public representations of policy (in its prospectus or offering circular and in marketing materials), and the activities of those charged with management of the pool demonstrate that the pool's primary business is investing or trading in commodity interests, rather than securities.[58]

Re-evaluation of the Commission Staff's Prior Concerns. In the case-by-case commodity pool letters issued by the staff since the Dodd-Frank Act, the staff has relied on a number of conclusions and assumptions that merit re-evaluation.

First, the staff has stated the following:

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56 In the Matter of the Tonopah Mining Company of Nevada, 26 S.E.C. 426 (July 22, 1947).

57 Division of Investment Management, No Action Letter Request Relating to the Status Under the Investment Company Act of 1940 of Certain Commodity Pool Funds of Funds (July 11, 1996) *available at* https://www.sec.gov/divisions/investment/noaction/1996/mfa071196.pdf.

58 Managed Futures Association (Ref. No. 96-94) (July 15, 1996).

> From the time of its adoption in 1981, the Commission has declined to constrain the phrase "operated for the purpose of trading" to the narrowest of possible interpretations.[59]

This formulation misstates the issue and sets up a false premise. The "narrowest of possible interpretations" is not at all what the commodity pool request letters sought, nor is it what we are suggesting here. The request is rather for a principles-based interpretation that gives meaning to the words Congress used and can be applied without a case-by-case staff analysis and blessing. This is hardly the "narrowest of possible interpretations." By contrast, the "single commodity interest" test would be the "broadest of possible interpretations" and thus far from the balanced approach the Commission sought in 1981.

Second, the staff letters have provided a regulatory rationale that does not fit the current regulatory situation for which we request relief:

> The reasons that the Commission articulated for rejecting a narrow understanding of the phrase were grounded in its dual concerns for customer and market protection.[60]

With respect to dual registrants, the SEC and its regulatory regime address the same customer protection goals as the Commission. Regarding market protection, the Commission now has tools for governing market participants far beyond those applicable to CPOs and that were not in place in 1981.

Third, we believe the staff is mistaken in its understanding of Congressional intent. A number of the 2012 "commodity pool" letters state the following:

> There is no evidence in the legislative record to indicate that when Congress adopted a statutory definition of "commodity pool," that is substantively identical to the Commission's longstanding regulatory definition of "pool," it intended for the Commission to modify its understanding of the scope of phrase "operated for the purpose of."[61]

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59 *See* CFTC Letters No. 12-13 (Oct. 11, 2012); No. 12-14 (Oct. 11, 2012).

60 *Id.*

61 *Id.*

It is a fundamental tenet of statutory construction that each word in a statute is intended to convey a meaning, and that the plain meaning of the word ordinarily governs.[62] Congress's determination to incorporate in the statutory definition the requirement that a commodity pool be "operated for the purpose of trading commodity interests" is in fact evidence that these words are to be taken seriously and treated as a meaningful component of the definition.[63] Where the effect of the Commission's prior interpretation of the phrase "operated for the purpose" was to negate the impact of those words, Congress's express determination to include the phrase as a key part of the definition should be viewed as a rejection of such an approach.

Arriving at a Workable Set of Principles. We recognize that previous case law and the SEC analogies may not provide a complete set of parameters that address both the Commission's and the industry's concerns. We would welcome the opportunity to engage in a dialogue with the staff with a view to developing an approach that will provide a long term, effective, and efficient regulatory approach to this pivotal issue.

Use of Regulation 4.5 Trading and Marketing Tests as a Safe Harbor. A principles-based definition of commodity pool along the lines described above would result in less need for the exemptions provided by Regulation 4.5 and Regulation 4.13(a)(3). However those rules, and the trading and marketing tests used in Regulation 4.5, would still serve as useful safe harbors that asset managers could rely on in cases where, for client relations, NFA Bylaw 1101, eligible contract participant qualification, or other purposes it may be considered necessary or appropriate to have additional documented certainty as to their CPO or CTA status.[64]

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62 *See, e.g.*, *Rake v. Wade*, 508 U.S. 464, 471 (1993) (quoting *Ex parte Public Nat. Bank of New York*, 278 U.S. 101, 104 (1928)) ("To avoid 'deny[ing] effect to a part of a statute,' we accord 'significance and effect ... to every word.'"); *American Tobacco Co. v. Patterson*, 456 U.S. 63, 68 (1982) ("As in all cases involving statutory construction, 'our starting point must be the language employed by Congress,'" quoting *Reiter v. Sonotone Corp.*, 442 U.S. 330, 337 (1979), "and we assume 'that the legislative purpose is expressed by the ordinary meaning of the words used[,]'" quoting *Richards v. United States*, 369 U.S. 1, 9 (1962)).

63 The importance of the "operated for the purpose" test in determining CPO status in particular was emphasized in *CFTC v. Equity Financial Group LLC et al,* 572 F.3d 150, 156 (3rd Cir. 2009), in which the Commission prevailed based on the Court's recognition that the purpose of the pool, rather than its actual trading activities, was determinative of commodity pool and CPO status ("A commodity pool operator must engage in a business of a particular form; it must solicit, accept, or receive funds, securities, or property; and the solicitation must have a particular purpose—trading commodity futures. The solicitation, acceptance, or receipt of funds must be 'for the purpose of trading,' but nothing in the statute imposes an actual trading requirement.").

64 The concept of Regulation 4.5 as a safe harbor is consistent with the Commission's approach in the original adoption of the rule. In that rulemaking, commenters had expressed concern that proposed Regulation 4.5 appeared to provide an exclusive means for relief from regulation as a CPO, and recommended that adoption of the rule 'should provide a regulatory 'safe harbor,' but not the exclusive

C. Recommendations

AMG recommends that the Commission provide principles-based guidance consistent the plain meaning of the CEA on which industry participants can rely in making reasoned determinations about whether a particular entity is a commodity pool for purposes of CPO and CTA registration. AMG would welcome the opportunity to work with the staff in coming up with an appropriate set of principles, which we believe should include:

1. A statement that "operated for the purpose" is an important element of the test and that mere holding or trading of a commodity interest by an entity does not create the presumption that the entity is a commodity pool;

2. Consideration of the purpose and extent of the entity's commodity interest trading relative to the securities trading, in a manner similar to the approach the SEC takes in determining whether commodity pools are investment companies;

3. Reference to the *Lopez* factors;

4. Clarification that the principles may be applied by market participants in a reasonable manner without the need for a staff determination; and

5. Guidance that market participants may rely on the trading and marketing tests set forth in Regulation 4.5 as a non-exclusive safe harbor for determining commodity pool and CPO status.

III. <u>CPO and CTA Registration and Regulation</u>: Avoid Cross Border Overreach

A. Commission's Regulatory Goal

As with any extraterritorial application of regulation, the Commission's aim in the cross-border application of its CPO and CTA registration and regulation provisions should be to focus on extraterritorial application that is authorized by Congress, in recognition of circumstances where there is a significant U.S. regulatory interest, such as a direct and significant connection with U.S. investors.

B. Excessive Regulatory Burdens and Adverse Impact

Previously, the Commission and staff have taken positions resulting in broad extraterritorial application of its CPO and CTA Regulation. Even where a fund is organized and operated outside of the U.S. and is not offered, marketed, or sold in the U.S., the Commission has taken the position

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means for relief from regulation as a CPO." The Commission agreed with this recommendation. *See* Regulation 4.5 1985 Adopting Release, *supra* note 5 at 15,870.

that "even one" U.S. investor in the fund results in the fund being a commodity pool requiring CPO and/or CTA registration by the operator and adviser (unless one of the exemptions applicable to U.S. CPOs and CTAs is available). This application is inconsistent with principles of international comity, as recognized by Congress in adopting Section 2(i) of the CEA, added by the Dodd-Frank Act, and the Commission in implementing Section 2(i), and with the use of reasonable *de minimis* U.S. investment thresholds widely used in other regulatory regimes, including the federal securities laws, and in a number of the Commission's own rules. It is also unworkable as a practical matter. The regulatory uncertainty in this area is exacerbated by the absence of an applicable definition of U.S. person.

The Commission has not reconsidered the appropriate extraterritorial reach of the CPO and CTA provisions of the CEA and the Commission's regulations as applied to global asset managers in light of two critical developments: (1) the Dodd-Frank Act's expansion of the definitions of commodity interest and commodity pool, which affects global markets, and (2) recent judicial precedents that confirm a presumption against extraterritorial effect of U.S. regulation absent specific evidence of Congressional intent to the contrary. [65] The absence of such a reconsideration has resulted in uncertainty for global asset managers and the potential for unnecessarily duplicative and restrictive regulation of offshore activities, which may also be in conflict with policies of local regulators. Moreover, it poses the danger that the Commission's assertion of extraterritorial CPO and CTA jurisdiction is beyond the bounds of Congressional intent and current jurisprudence.

These developments generally require exercise of restraint in imposing CPO and CTA registration and regulation on offshore entities and offshore activities. In this letter we do not address all situations in which such restraint is appropriate, but focus on four components of a framework designed to prevent excessive extraterritorial reach of the Commission's regulations on global asset managers: (1) replacing the "even one" U.S. investor test with a reasonable threshold that limits extraterritorial jurisdiction to situations where the Commission has a significant regulatory interest; (2) providing an appropriate definition of "U.S. person" for this purpose; (3) confirming that CPO and CTA exemptions for offshore activities can be combined with exemptions for U.S. activities under the Commission's longstanding activities-based "stacking" approach; and (4) clarifying the circumstances under which U.S. registered CTAs may treat their foreign affiliates as "participating affiliates" that may provide advisory personnel for U.S. clients, under appropriate supervision by the U.S. registered CTA, without the need for registration of the foreign affiliate (under a framework analogous to relief the SEC has provided, and which is referred to as the "Unibanco" line of no-action letters).

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[65] *See, e.g.*, *Morrison v. National Australia Bank*, 561 U.S. 247 (2010)("*Morrison*"); *In Re North Sea Brent Crude Oil Futures Litigation*, No. 13-md-02475 (ALC), 2017 WL 2493135 (S.D.N.Y. June 8, 2017).

1. Congress and the Commission's Recognition of Need for Restrained and Rational Approach to Extraterritorial Application of U.S. Laws

Both Congress and the Commission have long recognized the importance from a global perspective of limiting the extraterritorial reach of U.S. regulation to circumstances that implicate substantial U.S. interests. These limitations prevent excessive, duplicative, and conflicting cross border regulation and minimize regulatory uncertainty and complexity that can thwart innovation and hurt investors. They also foster productive global cooperation among regulators in diverse jurisdictions seeking to achieve similar regulatory goals in a harmonious fashion.

In terms of Congressional intent, in the 2010 seminal case of *Morrison v. National Australia Bank,* the U.S. Supreme Court has stated that "unless there is the affirmative intention of the Congress clearly expressed to give a statute extraterritorial effect, we must presume it is primarily concerned with domestic conditions . . . . When a statute gives no clear indication of an extraterritorial application, it has none."[66] Following *Morrison*, the U.S. Court of Appeals for the Second Circuit stated in *Loginovskaya v. Batratchenko* that the CEA is presumed to be primarily concerned with domestic conditions and has limited extraterritorial reach.[67]

Most provisions of the CEA are silent on extraterritorial application, and thus the *Morrison* doctrine would lead to a presumption against such application. In particular, the provisions of the CEA relating to registration and regulation of CPOs and CTAs do not expressly address the extraterritorial application of the Commission's authority in this area, other than by tying the CPO and CTA registration requirements to use of the means of interstate commerce.[68] Moreover, the statutory statement in CEA Section 4*l* (Commodity Trading Advisors and Commodity Pool Operators; Congressional Finding), which explains the Congressional reason for requiring CPO and CTA registration, appears to focus on the national public interest in regulating "onshore" activities.[69]

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66 *Morrison*, supra note 65, at 255 (internal quotation marks omitted).

67 764 F.3d 266 (2d Cir. 2014). *Loginovskaya* ruled that private suits under section 22 of the CEA must be based on transactions occurring in the territory of the United States.

68 Section 4m(1) of the CEA provides that it "shall be unlawful for any commodity trading advisor or commodity pool operator, unless registered under [the CEA], to make use of the mails or any means or instrumentality of interstate commerce in connection with his business as such."

69 The statutory statement of Congress's reasons for requiring CPO and CTA registration, codified in Section 4*l* of the CEA and predating the Dodd-Frank Act, states in pertinent part:

> It is hereby found that the activities of commodity trading advisors and commodity pool operators are affected with a national public interest in that, among other things— (1) their advice, counsel, publications, writings, analyses, and reports are furnished and distributed, and their contracts, solicitations, subscriptions, agreements, and other arrangements with clients take place and are negotiated and performed by the use of the mails and other means and instrumentalities of interstate commerce; (2) their advice, counsel, publications, writings, analyses, and reports customarily relate to

Congress did expressly address extraterritoriality in expanding the Commission's jurisdiction to include swaps by including section 2(i) of the CEA in Title VII of the Dodd-Frank Act. Section 2(i) states that the provisions of the CEA relating to swaps added by Title VII shall not apply to activities outside the U.S. unless those activities (1) have a direct and significant connection with activities in, or effect on, commerce of the U.S., or (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of the CEA that was enacted by Title VII. [70] Using the Section 2(i) framework as a guide for the application of the CPO and CTA provisions, which are silent on the question, at most the registration provisions applicable to CPOs and CTAs can apply to extraterritorial activities when those activities have a direct and significant connection with activities in, or effect on, commerce of the U.S., or when they contravene anti-evasion rules or regulations.[71]

The Commission has recognized the need to apply principles of international comity to the registration and regulation of non-U.S. CPOs and CTAs, first through no-action relief and later through codification of its position in Commission Regulation 3.10(c)(3)(i).[72] Also, the Commission, in interpreting the limits of CEA Section 2(i), has emphasized principles of international comity. The Commission's 2013 interpretive guidance regarding the cross border application of Title VII of the Dodd-Frank Act ("Interpretive Guidance), which addressed, among other things, the scope of the definition of "U.S. person" for purposes of Title VII swaps regulation, cited favorably the articulation of international comity principles in the Restatement (Third) of Foreign Relations Law

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> and their operations are directed toward and cause the purchase and sale of commodities for future delivery on or subject to the rules of contract markets or derivatives transaction execution facilities; and (3) the foregoing transactions occur in such volume as to affect substantially transactions on contract markets or derivatives transaction execution facilities.

The first two items of national public interest address investor protection, and can be reasonably understood to focus on U.S. persons, rather than offshore activity. With respect to the third item, which addresses market transactions, and thus goes beyond investor protection, this is where consideration of the Commission's enhanced market regulation powers after Dodd-Frank can accomplish the same goal more effectively than through regulation under Part 4.

[70] Note that when a statute provides for some extraterritorial application, the presumption against extraterritoriality operates to limit that provision to its terms. *Morrison*, 561 U.S. at 265.

[71] With respect to anti-evasion, this provision is directed at actions abroad that might conceal a domestic violation, or that might cause what would otherwise be a domestic violation to escape on a technicality. *Id.* at 264.

[72] Regulation 3.10(c)(3)(i), which was first adopted in 2007, excepts offshore CPOs and CTAs that trade on U.S. facilities on behalf of non-U.S. clients from Commission registration, subject to certain market protections imposed on the U.S. trades. As proposed, Regulation 3.10(c)(3) was designed for offshore FCMs and introducing brokers ("IBs"), and CPOs and CTAs were added in the final rule.

of the United States (the "Restatement").[73] Section 403 of the Restatement, among other things, provides that even where a country has a basis for jurisdiction, it should not prescribe law with respect to a person or activity in another country when the exercise of such jurisdiction is unreasonable.

The principles of international comity are also critical in implementing two of the core principles included in the President's February 2017 executive order: (e) advance American interests in international financial regulatory negotiations and meetings and (f) make regulation efficient, effective, and appropriately tailored.[74] As was evident from the prolonged dispute over clearinghouse recognition, assertions of extraterritorial jurisdiction outside of the principles of international comity can jeopardize any regulator's, including the Commission's, credibility and standing in important global negotiations, in contravention of core principle (e). With respect to core principle (f), unnecessary regulation of offshore activities that do not involve U.S. investors or threaten U.S. markets would be counter to the goal of efficient, effective, and tailored regulation.

2. Current Commission Approach Towards CPO and CTA Registration Is Not Aligned with Extraterritorial Principles

Despite the Congressional intent expressed through the CEA and the Commission's general stance on extraterritoriality, the Commission and its staff have taken positions on CPO and CTA registrations that result in overbroad exterritorial application to activities with immaterial connections to activities in, or effect on, commerce of the U.S. The Commission's expanded jurisdiction over swaps has exacerbated the problem, resulting in the potential for global reach of the Commission's CPO and CTA jurisdiction. At the same time, asset management has become a global business, and many U.S. asset managers have a global footprint. While these global organizations take pains to ensure that activities in different jurisdictions and with respect to residents of different countries comply with all applicable laws, a rational approach by the Commission is needed to ensure that the extraterritorial reach of U.S. CPO and CTA registration requirements will not unnecessarily encroach on offshore activities.

3. The Commission's "Even One" U.S. Investor Test

The Commission has taken the position that the presence of even a single U.S. person participant in an offshore pool can require an otherwise offshore adviser to register with the Commission as a CPO. For example, the Interpretive Guidance release states that, "Under

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73 Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45291, 45301 (July 26, 2013) ("Interpretive Guidance"), https://www.gpo.gov/fdsys/pkg/FR-2013-07-26/pdf/2013-17958.pdf.

74 Core Principles for Regulating the United States Financial System, Executive Order 13772 (Feb. 3, 2017), 82 Fed. Reg. 9965 (Feb. 8, 2017), https://www.federalregister.gov/d/2017-02762.

Commission regulation 3.10, the operator of a non-U.S. fund with ***even one U.S.-based owner*** is required to register as a commodity pool operator."[75]

This "even one U.S.-based owner" position cited is neither viable in practice nor appropriate to protecting any significant U.S. regulatory interest. As a practical matter, it presents a compliance burden that is impossible to administer. Offshore fund sponsors can be expected to control where and to whom their funds are offered and, for a number of reasons, in fact do take comprehensive and diligent measures to ensure that their offshore funds are not offered in the U.S. or to U.S. investors.[76] To this end, Undertakings for Collective Investment in Transferable Securities ("UCITS") funds offered in Europe, for example, typically prohibit investment by U.S. persons and include clear and complete prospectus disclosure to that effect. Sponsors of these funds also make arrangements with distributors to enforce these prohibitions.

Funds and their sponsors cannot, however, ensure that in fact not a single U.S. investor purchases an interest in the fund, that not a single non-U.S. investor later transfers that interest to a U.S. person, and that not a single non-U.S. investor later moves to the U.S. The impossibility of even knowing of such occurrences, much less preventing them, is especially true for publicly offered offshore funds, which are typically distributed by intermediaries and held in omnibus accounts, and for exchange traded offshore funds. If the global community took the Commission's words literally, the number of global managers that would be required to register with the Commission as CPOs and CTAs would skyrocket.

More importantly, the presence of "even one" U.S. investor creates no legitimate regulatory interest that merits CPO or CTA regulation. For this reason, it is far more common for regulators, including the Commission, in similar contexts to set a *de minimis* type of threshold, below which regulation is not required. For example, Commission Regulation 4.7, which designates certain offshore funds as non-U.S. persons, permits U.S. ownership of such funds of up to 10%.[77] As

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75 Interpretive Guidance, *supra* note 73, at 45301, note 149 (emphasis added).

76 Other regulatory reasons for doing so include compliance with Regulation S under the Securities Act and with the Foreign Account Tax Compliance Act ("FATCA"), as well as seeking to avoid engaging in activities that could raise U.S. CPO or CTA regulatory concerns.

77 Regulation 4.7(a)(1)(iv)(D) includes as a non-U.S. person:

> An entity organized principally for passive investment such as a pool, investment company or other similar entity; *Provided*, That units of participation in the entity held by persons who do not qualify as Non-United States persons or otherwise as qualified eligible persons represent in the aggregate less than 10% of the beneficial interest in the entity, and that such entity was not formed principally for the purpose of facilitating investment by persons who do not qualify as Non-United States persons in a pool with respect to which the operator is exempt from certain

another example, Regulation S, the offshore offering exemption under the Securities Act that was adopted by the SEC to prevent offers and sales to U.S. persons of securities that are not registered under that Act, takes a different approach tailored to the regulatory interest. Regulation S governs the offer and sale of the securities, and imposes requirements designed to prevent "flowback" to the U.S., but does not otherwise require issuers to police changes in the geographic location of shareholders after completion of the sale. Offshore funds already comply with Regulation S in order to avoid violating U.S. federal securities regulation requirements.[78]

Regulators also make allowances for "inadvertent" investors. For example, the SEC has granted no-action relief under the '40 Act to foreign funds in connection with investments by "snowbirds," which are investors who may have purchased interests in the fund while living at home in another country but who later relocate to the U.S. Such foreign funds, which would otherwise exceed statutory thresholds based on U.S. ownership, are not subject to the '40 Act when that ownership is due to the independent actions of the fund's securityholders, such as the subsequent relocation of foreign securityholders to the U.S. or offshore secondary market transactions not involving the foreign fund or its agents, affiliates or intermediaries.[79] This relief reflects recognition by the SEC that regulatory concern under the '40 Act is more appropriately triggered by activities undertaken by or on behalf of a foreign investment company, rather than by activities of the company's securityholders that occur outside the influence of the company or its affiliates.

> requirements of part 4 of the Commission's regulations by virtue of its participants being Non-United States persons.

[78] Regulation S under the Securities Act, as originally adopted in 1990 and as amended from time to time, establishes safe harbor procedures for the offshore sales of securities of foreign or U.S. issuers. The regulation includes two safe harbor provisions: (i) an issuer safe harbor and (ii) a resale safe harbor. Pursuant to Regulation S, an offshore transaction is excluded from the U.S. federal securities laws, provided that it meets two general conditions: (i) offers and sales are made in an offshore transaction (*i.e.*, outside the U.S.); and (ii) no directed selling efforts are made in the U.S. by (a) the issuer, a distributor, any of their respective affiliates, or anyone acting on behalf of any of the foregoing (in the case of the issuer safe harbor) or (b) the seller, an affiliate, or any person acting on their behalf (in the case of the resale safe harbor). In addition to the general conditions, Regulation S also imposes additional conditions depending on the nature of the issuer and the type of security being offered. For purposes of Regulation S, an "offshore transaction" takes place when the offer is not made to a person in the U.S. and either the buyer is outside of the U.S. (or the offeror reasonably believes that the buyer is outside of the U.S.) or the transaction is executed on an established foreign securities exchange or market.

[79] Investment Funds Institute of Canada, SEC No-Action Letter (Mar. 4, 1996), https://www.sec.gov/divisions/investment/noaction/1996/ificanada020696.pdf.

4. Lack of U.S. Person Definition for CPO and CTA Registration Regulations

The burdens and uncertainty caused by the "even one" U.S. investor test are exacerbated by the fact that there is no definition of "U.S. person" for this purpose. This is in contrast to other regulatory schemes addressing cross border issues, including Commission regulations. The staff has acknowledged this gap but no definition has been issued.[80]

There are a number of existing standards that the Commission could use to build a definition appropriate for CPO and CTA registration. These standards include the following two, which could be leveraged individually or in combination to address the existing gap:

<u>Precedent 1</u>**: Definition of Non-United States Person in Commission Regulations 4.7 and 4.14(a)(8).** Regulation 4.7, which conditions the relief it provides on sales only to qualified eligible persons, including "Non-United States persons," includes a multi-part definition of that term. Under paragraph (a)(i) of the Regulation, a Non-United States person means:

(A) A natural person who is not a resident of the United States;

(B) A partnership, corporation or other entity, other than an entity organized principally for passive investment, organized under the laws of a foreign jurisdiction and which has its principal place of business in a foreign jurisdiction;

(C) An estate or trust, the income of which is not subject to United States income tax regardless of source;

(D) An entity organized principally for passive investment such as a pool, investment company or other similar entity; *Provided*, That units of participation in the entity held by persons who do not qualify as Non-United States persons or otherwise as qualified eligible persons represent in the aggregate less than 10% of the beneficial interest in the entity, and that such entity was not formed principally for the purpose of

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80 The Commission has emphasized that the definition of "U.S. person" it has adopted in the Interpretive Guidance for purposes of cross-border application of Title VII is not intended to "address how the term 'person' or 'U.S. person' should be interpreted in connection with any other CEA provisions or Commission regulations promulgated thereunder."

facilitating investment by persons who do not qualify as Non-United States persons in a pool with respect to which the operator is exempt from certain requirements of part 4 of the Commission's regulations by virtue of its participants being Non-United States persons; and

(E) A pension plan for the employees, officers or principals of an entity organized and with its principal place of business outside the United States.

The same definition is used for purposes of Commission Regulation 4.14(a)(8), which refers specifically to the Non-United States person definition provided in Regulation 4.7.

<u>Precedent 2</u>: SEC Regulation S Definition of U.S. Person. As described above, SEC Regulation S provides safe harbors from the registration requirements of the Securities Act for offshore sales of securities of U.S. and foreign issuers, and includes a definition of U.S. person for purposes of determining the scope of offshore transactions that qualify for the safe harbor. Regulation S defines the term "U.S. person" as:

(i) Any natural person resident in the U.S. (as defined below);

(ii) Any partnership or corporation organized or incorporated under the laws of the U.S.;

(iii) Any estate of which any executor or administrator is a U.S. person;

(iv) Any trust of which any trustee is a U.S. person;

(v) Any agency or branch of a foreign entity located in the U.S.;

(vi) Any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person;

(vii) Any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident of the U.S.; and

(viii) Any partnership or corporation if (i) organized or incorporated under the laws of any foreign jurisdiction and (ii) formed by a U.S. person principally for the purpose of investing in securities not registered under the Securities Act, unless it is organized or incorporated, and owned, by accredited investors (as defined in Rule 501(a) of Regulation D promulgated under the Securities Act) who are not natural persons, estates or trusts.[81]

While asset managers can appreciate the Commission's desire to narrowly tailor its definition of a U.S. person for each regulatory context in which it is used, the absence of a definition of U.S. person for Regulation 3.10(c) purposes, especially when "even one" U.S. investor creates a registration requirement, creates an unworkable level of uncertainty. In addition, adoption of an entirely new definition of U.S. person for this purpose, instead of an existing definition, would result in additional burdens, by requiring CPOs to create and implement multiple screens, and potentially confusing disclosure, to ward off investors in multiple categories. This additional complexity would increase the regulatory risk of good faith errors. On the other hand, conforming the U.S. person definition used for Regulation 3.10(c) to existing definitions that serve similar purposes, and with which the global community is familiar, has many advantages.

The U.S. person definition in Regulation S is the obvious starting point. First, Regulation S focuses on facts that would be within the control of a pool's CPO, instead of those that are unknowable (*e.g.*, holders of public funds through intermediaries) or unpreventable (*e.g.*, persons moving to the U.S. without notifying the pool or its operator). A CPO can reasonably be expected to control the marketing efforts undertaken with respect to its pool, and can reasonably be held to a standard of reasonably believing that any buyer is located outside the U.S. Therefore, a CPO would be able to ensure compliance with the regulation through proper due diligence and proper disclosures in the pool's offering documents to the effect that U.S. persons are not eligible to purchase shares of the pool. Second, aligning Regulation 3.10(c) with Regulation S would allow asset managers to streamline their compliance efforts. Intermediaries around the globe are all well-versed in the application of Regulation S; they are familiar with the definition of U.S. person provided for that purpose and also have developed compliance systems to screen investors accordingly. Like Regulation 3.10(c), which focuses on the location of the investors, Regulation S is similarly focused on the location of the investor at the time of the sale.

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81 Rule 902(k) under the Securities Act of 1933. Regulation S also defines a number of specified persons as not within the term U.S. person. See Rule 902(k)(2).

The Commission could build onto Regulation S by incorporating the non-U.S. person definition in Regulation 4.7, which is already part of the Commission's CPO and CTA regulatory framework. In its current form, the Regulation 4.7 definition is less comprehensive than Regulation S, as it identifies persons that are not U.S. persons but does not define the entire universe of persons that might be considered U.S. persons. For that reason, we suggest that Regulation 4.7 would function best as a safe harbor, that is, persons fitting within the non-U.S. person definition of Regulation 4.7 would be permitted investors under Regulation 3.10(c), but persons falling outside of that definition would be assessed based on the broader definition in Regulation S.

5. No Express Guidance for Combining Regulation 3.10(c) with Other Exemptions

Currently, there is no express guidance confirming that an offshore CTA or CPO may rely on different exemptions or exclusions for its offshore versus onshore commodity interest trading or operating activities. As a result, it is possible that an offshore person's offshore activities, which have no connection to the U.S. or the person's activities in the U.S., could theoretically be interpreted as jeopardizing the person's reliance on valid exemptions or exclusions for its U.S. activities.

Historically, the Commission has recognized the importance of permitting persons engaged in CPO or CTA activities to combine exemptions, both with other exemptions and with Commission registration, for different parts of the person's business. This approach, sometimes referred to as "stacking," ensures that each area of the person's activities is appropriately regulated (either pursuant to registration or in accordance with the terms of the relevant exemption), while avoiding unnecessary over-regulation of properly exempt activities. The stacking approach is a perfect example of regulation that is efficient, effective, and tailored to the regulatory purpose for which it is intended.

Stacking effectively permits asset managers to rely simultaneously on different exemptions for different activities and clients. It is deeply engrained in the Commission's CPO and CTA regulatory framework.

Certain types of stacking are expressly addressed in Commission Regulations.[82] Most relevant for application in the cross border context, stacking with respect to offshore activities is

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[82] For example, Regulations 4.5 and 4.13(a)(3) permit persons to rely on both exemptions for different funds, and registered CPOs may rely on either exemption with respect to funds that comply with the requirements. That is, a registered CPO may serve in its registered capacity (in compliance with applicable Part 4 Regulations) with respect to some funds, while also relying on a Regulation 4.13(a)(3) exemption for other funds and/or a Regulation 4.5 exclusion for still others (*see* Regulation 4.5(g) and Regulation 4.13((e)(2)). Similarly, Regulation 4.14(c)(2) permits a registered CTA to function as if it were an exempt CTA with respect to certain clients, where a registration exemption for those specific clients would be available.

expressly contemplated by Regulation 4.14(a)(10). Regulation 4.14(a)(10) defines certain circumstances under which an adviser may rely on the Section 4m(1) statutory CTA exemption, which, as further described below, provides an exemption from registration for a CTA with a limited number of clients (no more than 15 during the previous twelve month period). Regulation 4.14(a)(10) provides a series of provisions that address how to "count" clients for the 15 client limitation in Section 4m(1). Offshore CTAs and U.S.-based CTAs are treated differently for this purpose. While U.S. based CTAs (CTAs that have their principal office and place of business in the U.S.) must count both U.S. and non-U.S. resident clients, offshore CTAs (CTAs that have their principal office and place of business outside the U.S.) are required to count only clients that are U.S. residents (not their non-U.S. clients).[83] This effectively permits the offshore CTA to rely on a different exemption or exclusion for its offshore commodity interest trading activities, which exemption or exclusion is not jeopardized by the U.S. CTA activities for which the CTA relies on Section 4m(1).

Importantly, the stacking approach is not limited to these express rules. The Commission and its staff have confirmed that the stacking approach works as a matter of principle to permit a person to combine exemptions, where each set of activities meets the requirements for the exemption claimed. Specifically, in the release accompanying its adoption of Regulation 4.14(a)(8), the Commission confirmed that a CTA could claim an exemption under Section 4m(1) of the CEA for one set of clients and new Regulation 4.14(a)(8) for a different set of clients.[84] In this context, the Commission explained the stacking principle as follows:

> [T]he Commission wishes to make clear that the relief provided by [Regulation] 4.14(a)(8) is mutually exclusive from that provided by section 4m(1), that is, **depending upon the nature of its activities a CTA may be exempt from registration as such under either or both provisions. Thus, the fact that a CTA who is claiming**

83 *See* Regulation 4.14(a)(10) ("Special Rules. For the purpose of paragraph (a)(10) of this section: . . . (C) A commodity trading advisor that has its principal office and place of business outside of the United States, its territories or possessions must count only clients that are residents of the United States, its territories and possessions; a commodity trading advisor that has its principal office and place of business in the United States or in any territory or possession thereof must count all clients."). The provision's approach is generally similar to the SEC's Touche Remnant doctrine, discussed *supra* note 36.

84 Section 4m(1), as described above, provides an exemption from CTA registration for a CTA who (1) during the course of the preceding twelve months, has not furnished commodity trading advice to more than fifteen persons and (2) does not hold himself out generally to the public as a commodity trading advisor. Regulation 4.14(a)(8) provides an exemption from CTA registration for investment advisers registered with the SEC under the Advisers Act (or in some cases exempt from SEC registration) that provide commodity interest trading advice solely to certain specified types of clients (including Regulation 4.5 funds) and in a manner that is solely incidental to their business of providing securities or other investment advice to such qualified clients.

> **exemption under [Regulation] 4.14(a)(8) has more than 15 clients for the purpose of that rule will not affect the CTA's ability to claim exemption under section 4m(1) for a different set of clients – *i.e.* clients who are other than [Regulation] 4.5 trading vehicles**.[85]

Commission staff later confirmed application of the stacking approach in conjunction with Section 4m(3) as well as Section 4m(1) in a 2005 interpretive letter. The requesting adviser sought and obtained confirmation that the adviser, "while relying upon the [CTA] registration exemption provided by Section 4m(3) of the [CEA] with respect to certain of its advisory activities, may simultaneously claim exemption from CTA registration pursuant to Regulation 4.14(a)(8) with respect to certain of its other advisory activities" (footnotes omitted). As the staff stated in the letter:

> Like Section 4m(1), Section 4m(3) provides a statutory exemption from CTA registration, if specified conditions are met. . . [I]n the case of Section 4m(3), the CTA relying upon that statutory registration exemption is also subject to regulation by the SEC as an investment adviser. **The Division sees no reason why the Commission's reasoning with respect to simultaneous reliance upon Section 4m(1) and Rule 4.14(a)(8) should not also apply where a CTA seeks to rely simultaneously upon Section 4m(3) and Rule 4.14(a)(8)**.[86]

Stacking for Regulation 3.10(c) would be consistent with the Commission's historical stacking approach, but guidance to that effect has not been expressly provided to date. In adherence with principles of international comity, it would permit offshore asset managers with some U.S. CPO or CTA activities to rely on Regulation 3.10(c) for their offshore activities involving non-U.S. persons (reasonably interpreted as described above), combined with other exemptions, where available for their U.S. activities. It would also permit offshore managers that choose to register as CPOs or CTAs for their U.S. activities to continue to rely on Regulation 3.10(c), and to treat Regulation 3.10(c) clients on an unregistered basis.

Stacking is also supported by the language of Regulation 3.10(c), both in its current form and as proposed to be amended. In its current form, Regulation 3.10(c) takes a transactional approach, rather than an entity-based approach. The exemption is available for transactions that meet the

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85 Final Rules: Relief From Regulation as a CTA (Regulation 4.14(a)(8)), 52 Fed. Reg. 41,975, 41,978 (Nov. 2, 1987) (emphasis added).

86 CFTC Interpretive Letter No. 05-13 (Aug. 15, 2005), http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/05-13.pdf. (emphasis added).

offshore conditions and are conducted on U.S. facilities in the manner described.[87] With respect to CPOs and CTAs, the exemption thus applies to a person located outside the U.S., engaged in CTA or CPO activities in connection with certain commodity interest transactions executed in the U.S., only on behalf of persons located outside the U.S., provided that any such commodity interest transaction is submitted through a Commission-registered FCM. The terms of the exemption do not address the status of activities other than such transactions. Regulation 3.10(c), as proposed to be amended, is intended to eliminate a source of confusion introduced in the 2013 amendment, which could be read to limit the availability of the exemption to cleared swaps. This was clarified by a staff letter in 2016, and is proposed to be codified in the amendment. In connection with this clarification, proposed Regulation 3.10(c) would be structured differently than the current version, but there is no indication in the release proposing the amendment that a fundamental change with respect to application of the rule is intended. Proposed Regulation 3.10(c), as amended, would be more similar in structure to Regulation 4.14(a)(8). With respect to the stacking approach, as described above, Regulation 4.14(a)(8) is the classic case of a rule that invites stacking, and the ability to do so has been confirmed by both the Commission and the staff.[88]

6. Ability to Use Participating Affiliates without Separate CTA Registration

The Commission has not developed a framework for defining the registration status of foreign affiliates of U.S. registered investment advisers. The SEC, in connection with evaluating the appropriate limits on the extraterritorial reach of the Advisers Act, established a framework referred to the "Unibanco approach" (by reference to the no-action letter in which it originated).[89] Under the Unibanco approach, a non U.S. advisory affiliate of an RIA (often termed a "participating

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[87] As indicated earlier, offshore managers for non-U.S. clients that do not use U.S. facilities do not need an exemption from CPO or CTA registration, as they do not meet the U.S. jurisdictional means nexus test.

[88] We understand that there may be general concerns about stacking exemptions from Part 3 with those in Part 4. Any such concern should not apply in this case. As noted above, Regulation 3.10(c)(3) was originally proposed as a Part 3 registration rule because it was designed for FCMs and introducing brokers, for which Part 4 exemptions are not available. In the final rule, the Commission decided to afford CPOs and CTAs similar cross border relief for their offshore activities, and as a practical matter, it made sense to include them in the rule as already proposed, rather than create a separate Part 4 rule. Accordingly, we do not think the location of the exemption in Part 3 versus Part 4 should affect the stacking analysis.

[89] The stacking approach described above is limited by the availability of exemptions that fit the particular activities. Reliance on Regulation 4.14(a)(10), which codifies the stacking approach for U.S. activities of offshore CTAs by counting only U.S. clients, and application of the general stacking approach to Regulation 3.10(c), which would separate offshore and U.S. activities for exemption purposes, together make significant progress in delineating the appropriate reach of the Commission's CPO and CTA jurisdiction. In some situations, the Unibanco approach provides additional flexibility while preserving the regulatory goals.

affiliate") shares personnel with, and provides certain services to U.S. clients through, the RIA without the participating affiliate registering under the Advisers Act."[90]

C. Recommendations

AMG recommends that the Commission:

1. Establish a reasonable threshold for U.S. interests that must be exceeded before asserting CPO/CTA jurisdiction (*e.g.*, U.S. investment cannot exceed 10%), together with a recognition of the need to exclude inadvertent U.S. investors and seed money provided by U.S. affiliates.

2. Establish a "U.S. person" definition to establish the scope of CPO/CTA registration requirements, potentially leveraging SEC Regulation S and Commission Regulation 4.7.

3. Confirm that CPO and CTA activities outside the U.S. and not involving investors that are U.S. persons (based on the above considerations) will not affect an offshore CPO or CTA's reliance on other available exemptions, through application of the Commission's longstanding stacking approach.

4. Provide a framework for defining the registration status of foreign affiliates of U.S. registered investment advisers (*i.e.*, adoption of a Unibanco approach).

IV. <u>Uncleared Swap Margin</u>: Align requirements with global market practices and remove seeded investment funds from consolidated calculations

A. Commission's Regulatory Goals

The Commission, with the U.S. prudential regulators, sought to address the G-20 commitments to improving OTC derivatives markets by, among other things, requiring collateralization of uncleared swaps through standards finalized in early 2016.[91] In formulating these standards, the Commission was seeking to address counterparty and systemic risks consistent with its obligation to balance these benefits against the costs of the finalized requirements.

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[90] See IM Information Update 2017-03, Information Update for Advisers Relying on the Unibanco No-Action Letters (March 2017). The SEC developed the Unibanco approach in connection with a comprehensive evaluation of the regulation of investment companies and advisers conducted on the occasion of the 50th anniversary of the two 1940 Acts. *See* Division of Investment Management, SEC, *Protecting Investors: A Half Century of Investment Company Regulation* 229 (1992).

[91] 81 Fed. Reg. 636 (Jan. 6, 2016) (the "Final Margin Rule").

B. Excessive Regulatory Burden and Adverse Impacts

1. Undue Expense and Operational Complexity Due to Non-Core Prescriptive Requirements

While the Commission's margin requirements for uncleared swaps, at their core, address the Commission's counterparty and systemic risk concerns without undue burden and expense, some prescriptive requirements have and continue to generate unnecessary expense and operational complexity. AMG believes that the cause of these problems stem unnecessary departures from existing market conventions that were already in place to address the same counterparty risks. These requirements include the following:

T + 1 requirement for collecting/posting margin. Commission Regulations 23.152 and 23.153 require swap dealers to collect from/post to their counterparties initial margin and variation margin on "T+1," the business day after execution of the trade and after valuation changes result in additional variation margin becoming due.[92] This standard provides an unnecessarily narrow timeframe to complete these margin transfers. Prior to the uncleared swap margin rules becoming effective, voluntary margin arrangements generally utilized a T+5 margin transfer timing to reduce the overall number of transfers, allow cash management operations to work efficiently and allow rehypothecated collateral to be available when needed. A longer timeframe also provides the flexibility to address cross-border coordination of currencies and foreign securities.

While we are not advocating for a return to T+5 timing, a time frame slightly longer than T+1—even one that required a counterparty or dealer to *instruct* the movement of collateral on T+1, with the actual transfer taking place through ordinary operational processes—would greatly reduce burden without materially increase the credit risk between counterparties.

Minimum transfer amount. Commission Regulations 23.152(b)(3) and 23.153(c) permit a swap dealer to apply a minimum transfer amount of up to $500,000 to transfers of initial and variation margin to "alleviate the operational burdens associated with making de minimis margin transfers."[93] The rigidity around interpretation of the minimum transfer amount, particularly how to address this issue for clients with multiple asset managers, has caused significant burdens.[94] We appreciate that Division of Swap Dealer and Intermediary Oversight ("DSIO") granted no action relief allowing a lower minimum transfer amount for separately managed accounts;[95] however, we believe the issue should be addressed through a more principle-based approach and by final changes to the regulation.

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92 Commission Reg. § 23.152 and § 23.153.

93 Final Margin Rule, 81 Fed. Reg. at 653.

94 See SIFMA AMG's prior letter dated November 7, 2016, available at: https://www.sifma.org/resources/submissions/sifma-amg-submits-letter-to-the-prudential-regulators-and-cftc-regarding-minimum-transfer-amount-for-uncleared-swaps-margin-requirements/.

95 CFTC Letter No. 17-12, available at: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/17-12.pdf.

2. Unnecessary Posting of Initial Margin for Seeded Investment Funds

The uncleared swap margin rules do not exclude seeded investment funds (*i.e.*, investment funds initially funded with seed capital by a sponsor and consolidated on the sponsor's or the sponsor's group's financial statements) from consolidated initial margin calculations. As a consequence, initial margin requirements, intended to apply to market participants with large swaps exposure, are being applied to seeded investment funds, among the smallest market participants.

Commission Regulation 23.151 defines "margin affiliate" purely on a consolidated accounting basis and without distinguishing between fund vehicles and ordinary corporate affiliates. When the term "margin affiliate" is applied to Commission Regulation 23.151's definitions of material swaps exposure ("MSE") and initial margin threshold amount ("IMTA") calculations, a seeded investment fund that is consolidated onto the balance sheet of an organization with other swaps trading activity becomes part of a larger group calculation and may have to post initial margin.

Seeded investment funds do not have uncleared swaps exposures that pose significant risks to swap counterparties or the financial system, and have a markedly different relationship with their sponsor than an ordinary corporate affiliate. A seeded investment fund will typically have more than 50% ownership from a fund sponsor and, as a result, will generally be consolidated onto the sponsor's financial statements and be the sponsor's margin affiliate under the Commission's uncleared swap margin rules. Investment funds at the seeding phase tend to be small and, as a result, do not typically have uncleared swaps exposure that would present significant risk to a swap counterparty or the financial system. While a sponsor of a seeded investment fund has influence over the fund beyond that of a passive, unaffiliated investor, a seeded investment fund is by no means the same as a corporate affiliate. For example, seeded investment funds that are registered as management companies under the '40 Act are overseen by an independent board of directors/trustees and managed by a registered investment adviser that has fiduciary duties of care and loyalty to the fund and *all* investors in the fund. Similar features are present for unregistered funds relying on an exemption from registration under Section 3(c)(1) or 3(c)(7) of the '40 Act. Additionally, all seeded investment funds are distinct legal entities that are managed by an investment adviser pursuant to an investment advisory agreement that, among other things, requires the assets of the fund to be managed in accordance with specified investment guidelines, objectives and strategies and not capriciously at the desire of the fund sponsor. To suggest that a fund under such circumstances should be treated like any other corporate affiliate is inconsistent with these overriding structural, fiduciary and contractual safeguards. Notwithstanding these characteristics, the Commission's uncleared swap margin rules provide no exclusion for seeded investment funds from consolidated margin calculations.

Inclusion of seeded investment funds with the sponsor's MSE and IMTA calculations will negatively impact seeded investment funds and is inconsistent with the purpose and policy of the Commission's uncleared swap margin rules. Given that a seeded investment fund will often be consolidated on the sponsor's financial statements, MSE calculations of the seeded investment fund will include the sponsor along with any other margin affiliates of the sponsor and, if the threshold is exceeded, will require even the smallest seeded investment fund to post initial margin when, absent the application of the margin affiliate definition, it would not be required to do so. If the sponsor has a swap dealer affiliate or is in a family of companies that includes a financial company, a large corporate or insurance entity that uses swaps for hedging, this result will be a foregone conclusion.

This outcome is not consistent with the intended purposes of measuring uncleared swaps exposure on a consolidated basis. For example, the final rules' release indicate that margin affiliates are included in calculations of MSE and IMTA as a simplified means to prevent companies from using shell companies and netting sets without economic basis to evade margin requirements.[96] These concerns, however, are not implicated in the case of seeding new investment funds; seeded investment funds are created for a bona fide business and economic purpose, are typically overseen by an independent board (or equivalent) and are always managed by an investment adviser having fiduciary duties to the entity in accordance with a specified investment program. Further, seeded investment funds are distinct legal entities and, unlike arrangements often present among corporate affiliates, are not collateralized by or otherwise supported by the fund sponsor (apart from the fund sponsor's initial contribution of seed capital) or any other entity.

Requiring seeded investment funds to post initial margin along with the largest swap dealers and counterparties, potentially beginning as early as September 2016, is also illogical given that (i) seeded investment funds typically have small, uncleared swaps exposures that do not pose significant risks to swap counterparties or the financial system; (ii) the sponsor does not exercise corporate control over the investment fund; (iii) the seeding is temporary; and (iv) the sponsor's ownership percentage will diminish as unaffiliated investors join the fund. While the final rule's release indicate the view that the treatment of newly seeded investment funds is appropriate because the sponsor may own up to 100 percent of the fund,[97] as discussed above, the structural, fiduciary and contractual features of seeded investment funds provide crucial safeguards not addressed or recognized by the Final Margin Rules. Further, if in fact an entity uses seeded investment funds in an abusive, evasive manner, the Prudential Regulators or the Commission can use their anti-evasion authority to counter such activity.

Applying the margin affiliate definition to seeded investment funds will also cause the uncleared swaps activity of a seeded investment fund to be impacted by unrelated swaps activity of the sponsor and the sponsor's other margin affiliates (including the sponsor's other seeded investment funds) through both the MSE and IMTA calculations, and lead to problems for investment advisers managing seeded investment funds. For example, where the sponsor has multiple seeded investment funds, the uncleared swaps activity and the MSE calculations of one fund will impact the MSE calculations of the others in determining whether any must post initial margin, and the IMTA will need to be shared among the funds (notwithstanding their entirely separate investment activities) for any common swap dealer counterparty. Because the posting of initial margin causes funds to incur costs and, as such, impacts fund performance, the sharing of these calculations across funds leads to problems and complexities that ultimately will negatively impact unaffiliated investors. These complexities are only increased in cases where there are multiple investment advisers to seeded investment funds that are consolidated on the balance sheet of a single sponsor. Funds must be managed independently from each other and their sponsors.

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[96] 81 Fed. Reg. 636, 651.

[97] 81 Fed. Reg. 636, 647.

Yet the uncleared swap margin rules' calculations require that the uncleared swaps activity of seeded investment funds be managed and monitored on a consolidated basis, potentially requiring decisions that pit one seeded investment fund against others that are margin affiliates as well as against their sponsors and their sponsors' other margin affiliates (such as in allocations of the IMTA).

C. Recommendations

AMG recommends that the Commission:

1. Interpret or revise the T+1 timing requirement for margin transfers to provide greater flexibility, such as through allowing transfer instructions to be issued on T+1, with the actual transfer taking place through ordinary operational processes.

2. Move to a more principles-based interpretation and application of minimum transfer amounts.

3. Exclude seeded investment funds from consolidation for the purposes of MSE and IMTA calculations.

4. Consider other inefficiencies in the uncleared swap margin rules that could reduce burdens without undermining regulatory aims.

V. <u>Commission Regulations Part 40</u>: Strengthen Commission Authority to Address DCM, SEF, DCO and SDR Rule and Contractual Changes

A. Commission's Regulatory Goals

Through Part 40 of the Commission's Regulations, the Commission aimed to provide a tiered review process for new rules, rule amendments and changes to contractual terms prescribed by designated contract markets ("DCMs"), registered swap execution facilities ("SEFs"), registered derivatives clearing organizations ("DCOs"), and registered swap data repositories ("SDRs"). For non-material changes to agricultural contracts, minor changes and changes to non-agricultural contracts, the Commission provided methods for certification and self-certification. At the same time, the Commission sought to maintain oversight over important rule changes, which when Part 40 was established in its current form were material changes to a term or condition of a contract for future delivery of an enumerated agricultural commodity listed in Section 1a(9) of the Commodity Exchange Act, or an option on such a contract or commodity, in a delivery month having open interest.

B. Excessive Regulatory Burden and Adverse Impacts

AMG has observed that Part 40's exception for less important rule changes has swallowed the rule, leaving little that is reviewed or capable of challenge by the Commission. Over time, more changes—even those effecting agricultural contracts—have been submitted for certification with a mere 10 days for market participants to react. And even when objections are raised, unless the rule presents a clear conflict between the rule or contractual change and the CEA —a low bar for DCMs, SEFs, DCOs, and SDRs to pass—the Commission's regulations do not give the

Commission or its staff the power to halt the change. Rule or contractual changes presenting novel or complex issues can be stayed for up to 90 days but, again, this standard is not tied to the overall policy objectives of the Commission.

In addition to substantive changes being made without the Commission having tools to review and challenge, Part 40's standards are outdated, based on the Commission's jurisdiction prior to the Dodd-Frank Act. As the markets overseen by the Commission have evolved and the Commission's jurisdiction has expanded, the need to review material changes beyond those effecting enumerated agricultural commodities has only increased.

Changes to DCM, SEF, DCO and SDR rulebooks can alter protections and burdens within Commission-regulated markets. As such, the Commission should modernize the tools available to it and its staff to review and, in some instances, halt rule and contractual changes that may be objectionable.

C. Recommendations

AMG recommends that the Commission amend Part 40 to require Commission review for all material rule and contractual changes by DCMs, SEFs, DCOs, and SDRs and that the Commission be able to object to any such change it deems to be inconsistent with Commission policy, including considerations of compliance costs and customer protections that are impacted by the rule or contractual changes.

AMG further believes that the Commission should consider modernizing Part 40's language to make it better fit the expanded set of rulebooks covered so that interpretation of Part 40 can be more straight forward and certain.

VI. Additional Registration Recommendations

In addition to the foregoing, AMG recommends that the Commission revise external business conduct standards to target market needs more efficiently. For example, pre-trade mid-market marks required by Commission Regulation 23.431(a) create unnecessary burden upon dealers. While these burdens are not imposed upon asset managers or their clients, costs imposed upon dealers translate into higher costs for investors utilizing swaps for investment strategies.

For specific burdens and recommendations, we refer you to the letter filed by SIFMA Re: Commodity Futures Trading Commission Request for Public Input on Simplifying Rules (Project KISS); External Business Conduct Requirements.

In addition to those addressed in the SIFMA letter, AMG believes that Commission Regulation 23.434 should be revised to eliminate unnecessary representations required by counterparties advised by a registered commodity trading advisor or an SEC-registered investment adviser. AMG believes this requirement is too broad. A counterparty advised by a commodity trading adviser or investment adviser should not to be required to indicate that they comply with policies and procedures reasonably designed to ensure that the person responsible for evaluating the recommendation and making trading decisions on behalf of the counterparty are capable of doing so. Such circumstances are already established when a commodity trading adviser or investment adviser is involved in the transaction, making the representation a meaningless step.