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Dechert Comment Letter Regarding the Final Rules Amending Part 4 of the CFTC's Regulations [RIN number 3038-AD30]

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Commodity Futures Trading Commission
Three Lafayette Centre
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Washington, DC 20581

Re: Final Rules Amending Part 4 of the CFTC's Regulations [RIN number 3038-AD30]

Dear Mr. Stawick:

Dechert LLP ("**Dechert**") appreciates this opportunity to comment on the final rules ("**Final Rules**") adopted on February 9, 2012[1] by the Commodity Futures Trading Commission ("**CFTC**") under the Commodity Exchange Act as amended ("**CEA**")[2] in anticipation of the scheduled April 24, 2012 effective date of the Final Rules and the release of a related Q & A which we understand the CFTC staff plans to issue prior to such effective date. The Final Rules (i) modify and eliminate certain CFTC registration exclusions and exemptions widely used by sponsors of investment companies registered under the Investment Company Act of 1940 as amended ("**1940 Act**")[3] ("**mutual funds**") as well as private investment funds, and (ii) adopt new forms for reporting by commodity pool operators ("**CPOs**") and commodity trading advisors ("**CTAs**").

This comment letter focuses on: (i) the effects of the changes to CFTC Regulation 4.5 ("**Regulation 4.5**")[4] which, prior to this rulemaking, excluded mutual funds and their sponsors from the definition of CPO (among other persons); (ii) the consequences of certain changes to

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1 Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11252 (Feb. 24, 2012) ("**Adopting Release**").

2 7 U.S.C. § 1 *et seq*.

3 15 U.S.C. § 80a-1 *et seq*.

4 17 C.F.R. § 4.5. *See also* 7 U.S.C. § 1a(11), defining the term "commodity pool operator."

CFTC Regulation 4.13(a)(3) ("**Regulation 4.13(a)(3)**")[5] and the rescission of CFTC Regulation 4.13(a)(4) ("**Regulation 4.13(a)(4)**")[6] as applied to private funds and wholly-owned offshore subsidiaries ("**CFCs**") of mutual funds; (iii) the new reports that CPOs and CTAs must file on CFTC Forms CPO-PQR and CTA-PR as required by new CFTC Regulation 4.27 ("**Regulation 4.27**")[7]; and (iv) various other related issues. We respectfully believe that the Final Rules, as adopted, require clarifying guidance from the CFTC and/or its staff, and also require certain specific amendments to avert unintended negative consequences (including inefficient and overly burdensome or broad regulation) and to make certain clarifications. In each section that follows below, we discuss the clarifying guidance that we are requesting the CFTC to provide and the rule amendments that may be appropriate or necessary.

Dechert and many of its clients have provided numerous comment letters as well as other information during this rulemaking process, and some of our comments, observations, and suggestions continue to be valid and desirable in making the Final Rules workable.[8]

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[5] 17 C.F.R. § 4.13(a)(3).

[6] 17 C.F.R. § 4.13(a)(4).

[7] 17 C.F.R. § 4.27.

[8] Over the course of this rulemaking process, Dechert submitted four comment letters to the CFTC and advised on several others, addressing various aspects of the proposals. Letter from M. Holland West, Partner, Dechert LLP, to David A. Stawick, Office of the Secretariat, CFTC (Oct. 18, 2010), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26313&SearchText=, Letter from George J. Mazin, Partner, Dechert LLP, to David A. Stawick, Office of the Secretariat, CFTC (Apr. 12, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42176&SearchText=, Letter from Dechert LLP and Clients, to David A. Stawick, Office of the Secretariat, CFTC (Apr. 12, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42183&SearchText=, Letter from M. Holland West, Partner, Dechert LLP, to David A. Stawick, Office of the Secretariat, CFTC (July 26, 2011) *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47953&SearchText=.

Regulation 4.5

Director and Trustee Liability

The CFTC stated in the Adopting Release that it agreed "that the investment adviser [to a mutual fund] is the most logical entity to serve as the [mutual fund's] CPO" where the mutual fund does not qualify for CPO registration relief under Regulation 4.5. The CFTC also stated that requiring registration of the mutual fund's board members with the CFTC "would raise operational concerns for the [mutual fund] as it would result in piercing the limitation on liability for actions undertaken in the capacity of director." As a result, it is clear that mutual fund board members (in their capacity as such) are not subject to any registration, regulation, or compliance requirements as CPOs themselves or as associated persons of a CPO, which suggests that Regulation 4.5 is not intended to expand mutual fund director and trustee liability under the CEA.

However, because the board members of a mutual fund are responsible for selecting and overseeing the fund's investment adviser, the treatment of a mutual fund as a commodity pool and the registration of its investment adviser as a CPO may expose the directors or trustees of the fund to increased risks of liability under the CEA's anti-manipulation and anti-fraud provisions

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Dechert has also published numerous clients alerts on this rulemaking: NFA Petitions for Rulemaking to Amend Regulation Excluding Registered Investment Companies from CFTC Regulation (Aug. 27, 2012) *available at* http://www.dechert.com/NFA_Petitions_for_Rulemaking_to_Amend_Regulation_Excluding_Registered_Investment_Companies_from_CFTC_Regulation_08-27-2010; Proposal to Rescind CFTC Registration Exemptions Will Affect Many Public and Private Investment Funds (Feb. 11, 2011) *available at* http://www.dechert.com/Proposal_to_Rescind_CFTC_Registration_Exemptions_Will_Affect_Many_Public_and_Private_Investment_Funds_02-11-2011; Proposal to Rescind CFTC Registration Exemptions Will Affect Many Hedge Funds and Other Private Investment Funds (Mar. 3, 2011) *available at* http://www.dechert.com/Proposal_to_Rescind_CFTC_Registration_Exemptions_Will_Affect_Many_Hedge_Funds_and_Other_Private_Investment_Funds_03-03-2011; CFTC Adopts Rule Changes and Rescinds Rule 4.13(a)(4), (Feb. 15, 2012) *available at* http://www.dechert.com/CFTC_Adopts_Rule_Changes_and_Rescinds_Rule_413a4_02-15-2012; CFTC Changes Rules Affecting Public and Private Funds, (Mar. 1, 2012) *available at* http://www.dechert.com/CFTC_Changes_Rules_Affecting_Public_and_Private_Funds_03-01-2012.

and other provisions of the CEA and CFTC regulations that are applicable to CPOs. A person excluded from the definition of CPO is generally not subject to the prohibition on fraudulent activities under Section 4o of the CEA, but is still subject to the prohibitions under the CEA applicable to all market participations, such as the prohibition on fraudulent transactions under Section 4b of the CEA.[9]

Moreover, all persons participating in the commodity markets are subject to general anti-fraud and anti-manipulation provisions of the CEA. Notably, Section 753 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 6 of the CEA by adding general prohibitions of fraud and manipulation that parallel Rule 10b-5 under the Securities Exchange Act of 1934 as amended.[10] The new provisions state that it is "unlawful for *any person*, directly or indirectly, to use or employ, or attempt to use or employ, in connection with any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, any manipulative or deceptive device or contrivance" in contravention of rules to be promulgated by the CFTC.[11] The CFTC subsequently adopted CFTC Regulations 180.1 and 180.2 to implement the new CEA provisions.[12] These rules broadly prohibit fraud and manipulation in connection with any swap, contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity.[13] Section 22(a) of the CEA provides a private right of action for damages against any

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9 *See* Commodity Pool Operators; Exclusions for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Pool Operator," 50 Fed. Reg. 15868, 15870 (Apr. 23, 1985). In addition, CFTC Regulation 4.15 extends the applicability of Section 4o to exempt CPOs. 17 C.F.R. § 4.15.

10 *See* §§6(c)(1) and 6(c)(3) of the CEA, 7 U.S.C. §9, as amended by Pub. Law 111-203, title VII, §753(a). 17 C.F.R. § 240.10b-5

11 7 U.S.C. §9(1) (emphasis added).

12 Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398 (July 14, 2011).

13 *Id.*

person[14] who violates the CEA or "who willfully aids, abets, counsels, induces or procures the commission of a violation" of the CEA.[15]

However, as a result of registration, a mutual fund's investment adviser-CPO will be subject to additional liability and disclosure liability under Section 4o of the CEA as compared to an adviser qualifying for an exclusion from the definition of a CPO. The CFTC and mutual fund shareholders therefore may potentially bring additional actions against the directors or trustees of a mutual fund and potentially hold them individually liable for the actions of the fund's investment adviser that is a registered CPO pursuant to Section 4o. For example, if the CPO of a mutual fund provides incomplete or deficient disclosure to fund shareholders, the CFTC or a shareholder of the fund who suffered financial losses in connection with the violation might bring legal action under Section 4o against both the fund's CPO and board, arguing that the CPO committed the violation and the board either aided, abetted, induced, or procured, or were negligent or in breach of a duty in connection with, the violation in relation to the board's general oversight function.

The actions of mutual fund directors and trustees are generally subject to state law duties of care and loyalty, and, so long as they appropriately exercise their fiduciary duties to fund shareholders, liability for these actions is limited. They additionally are protected by the "business judgment rule" under state law. As noted above, CPOs (and potentially fund boards) are also subject to liability under various generally applicable provisions of the CEA. Any additional liability under the CEA could discourage qualified persons from serving as mutual fund directors and trustees, and could increase the costs of insurance and compliance practices for relevant mutual funds. In light of the protections already afforded to investors under applicable commodities and securities laws, we believe that there is no compelling reason that private litigants or the CFTC should have expanded causes of action against mutual fund directors and trustees under the new Regulation

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[14] Other than a registered board of trade, derivatives transaction execution facility, derivatives clearing organization, or electronic trading facility, subject to certain conditions.

[15] 7 U.S.C. §25.

4.5 regime. We recommend that the CFTC confirm that it did not intend that the Final Rules create additional liability for directors and trustees of a mutual fund with an investment adviser that must now register as a CPO.

Funds-of-Funds

The CFTC stated in the Adopting Release that it "has not developed a comprehensive view regarding the role of fund of funds in the derivatives markets, in part, due to a lack of data regarding their investment activities," and withheld consideration of an exemption for funds that do not directly invest in commodity interests but do so through a fund-of-funds structure. The CFTC also stated that "a fund investing in an unaffiliated commodity pool is itself a commodity pool." As a result, the investment adviser to a mutual fund that invests in other commodity pools that do not qualify for an exclusion or exemption for their advisers from the definition of CPO also may not qualify for an exclusion under Regulation 4.5.[16]

The Regulation 4.5 exclusion from the definition of CPO presents substantial implications for mutual funds that invest in one or more underlying mutual funds that are subject to dual SEC and CFTC regulation due to the level of their trading in commodity interests being above the 5% and 100% Trading Limits (as applicable). It is likely that many such mutual funds-of-funds and their investment advisers will find that (i) it is difficult or impossible to monitor the levels of

[16] Under the Final Rules, in order to rely on the CPO registration exclusion in Regulation 4.5, a mutual fund must represent that, with respect to exchange-traded commodity futures, options on such futures, and commodity options and certain over-the-counter swaps, in each case used for purposes other than solely *bona fide* hedging purposes (as determined under CFTC Regulations 1.3(z)(1) and 151.5), either: (i) the aggregate initial margin and premiums required to establish the mutual fund's positions in such instruments will not exceed 5% of the liquidation value of the mutual fund's portfolio (after accounting for unrealized profits and unrealized losses on such instruments) (**"5% Trading Limit"**); or the aggregate net notional value of such instruments, determined at the time of the most recent position established, does not exceed 100% of the liquidation value of the mutual fund's portfolio (after accounting for unrealized profits and unrealized losses on such instruments) (**"100% Trading Limit"**). *See* 17 C.F.R. §4.5(c)(2). (For ease of reference herein, the 5% Trading Limit, the 100% Trading Limit, and similar limits under other CFTC regulations are referred to together as **"Trading Limits."**)

commodity interest trading at the underlying fund level in real time, and (ii) the CFTC's CPO registration requirement is prohibitively burdensome, and as a result such investment advisers will not invest in underlying funds that do not qualify for an exclusion or exemption under Regulation 4.5 or another rule and are therefore subject to dual SEC and CFTC regulation.

In addition, the Adopting Release rescinds the former Appendix A to Part 4, Guidance on the Application of Regulation 4.13(a)(3) in the fund-of-funds context ("**Former Appendix A**"), which provided guidance on the application of the Trading Limits of Regulation 4.13(a)(3), and replaced it with the new reporting form for CPOs, Form CPO-PQR. We recommend that the CFTC reinstate Former Appendix A with amendments and clarifications to reflect the various recent regulatory developments (*e.g.*, the amendment of Regulation 4.13(a)(3) to include references to swaps) and update Former Appendix A so that it covers each exemption that includes a Trading Limit, including Regulations 4.5, 4.12 ("**Regulation 4.12**"),[17] and 4.13(a)(3) and all of the Trading Limits therein.

Where an underlying fund is subject to dual SEC and CFTC regulation, requiring the investing mutual fund-of-fund's investment adviser to register with the CFTC does not provide compelling additional investor protections or benefits to the CFTC if it exceeds the 5% and 100% Trading Limits. The CFTC should continue to gather data (including cost data) to better understand funds-of-funds. In particular, the CFTC should focus on identifying data that will enable it to determine whether a broadened exemption for a mutual fund-of-funds is appropriate. Once it has collected and reviewed such data, the CFTC should consider amending Regulation 4.5 to provide a CPO registration exemption for a mutual fund-of-funds or higher Trading Limit thresholds.

Sub-Advised Commodity Interest Sleeves and Subsidiaries

Generally, the primary investment adviser to a mutual fund or CFC, as opposed to an investment sub-adviser to all or a portion of such mutual fund or CFC that is trading commodity interests,

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[17] 17 C.F.R. § 4.12.

would be required to register as CPO if it is unable to qualify for an exclusion under Regulation 4.5. However, where a mutual fund invests all or a portion of its assets in commodity interests and an investment sub-adviser that is registered as a CPO and CTA conducts all of the commodity interest trading for the fund, sleeve, or pool (as applicable), there is compelling justification for an exemption of the primary investment adviser from registration with the CFTC. The sub-adviser is already subject to dual registration with, and regulation by, the SEC and CFTC. We do not believe that there are compelling additional protections to investors or benefits to the CFTC in requiring the primary mutual fund or CFC investment adviser to register with the CFTC where it already has insight into the fund through the sub-adviser. We recommend that the CFTC provide guidance on situations in which it would be appropriate to rely on a mutual fund's or CFC's sub-adviser's CPO registration status rather than that of its primary investment adviser.

Equitization of Cash and Bona Fide Hedging

In the Final Rules, the CFTC staff expressed the view that equitization of cash through the purchase of futures contracts, in anticipation of purchasing underlying securities at a later date, among other uses of derivatives for risk management purposes, does not fall within the scope of *bona fide* hedging under Regulation 1.3(z), incorporating the definition of *bona fide* hedging from Regulation 151.5.[18] This is inconsistent with prior CFTC positions, and we recommend that the

[18] Until the CFTC adopted final rules including a new statutory definition of *bona fide* hedging transactions for exempt and excluded commodity transactions on November 18, 2011, the principal definition of *bona fide* hedging was provided in Regulation 1.3(z). The proposed rules were issued in advance of the adoption of Regulation 151.5, and therefore only referenced Regulation 1.3(z) in their discussion of *bona fide* hedging. The Final Rules reference both Regulation 151.5 and Regulation 1.3(z). *See* new §151.5 at 76 Fed. Reg. 71626, 71643 (Nov. 18, 2011). *See* Adopting Release at n.49. On March 22, 2012, the CFTC's Division of Market Oversight issued an advisory to remind market participants that, until 60 days after the CFTC and SEC publish jointly adopted rules further defining the term "swap," CFTC Regulations 1.3(z) and 1.48 will continue to apply to position limits. After the new definition is effective, the bona fide hedging provisions of Regulation 151.5 will apply to position limits for exempt and agricultural commodities and Regulation 1.3(z) will apply to excluded commodities. Bona Fide Hedge Treatment under the Commission's Position Limit Regulations, CFTC Division of Market Oversight Advisory (Mar. 22, 2012) *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/dmoadvisory1_3_1_48_032712.pdf.

CFTC amend the Final Rules to allow mutual funds to treat cash equitization as *bona fide* hedging.

In a mutual fund's normal course of business, there are periods of time during which the mutual fund has excess cash, but not enough to justify the transaction costs and other commercial and operational considerations involved in taking new positions in equities. Until sufficient capital is accumulated for the new position, it is common practice for the fund to equitize this cash by investing in equity index futures. Other mutual funds may equitize cash by purchasing futures contracts solely for annual or other infrequent portfolio rebalancing purposes. In each case, the mutual fund obtains equity exposure for idle cash, thereby remaining fully invested without incurring the high transaction costs of actually purchasing the equities.

The CFTC has historically treated anticipatory hedging as a *bona fide* hedging activity. Section 4(a) of the CEA, under which Regulation 151.5 is promulgated, directs the CFTC to engage in rulemaking to mitigate or eliminate excessive speculation that causes "sudden or unreasonable fluctuations or unwarranted changes in the price of [a] commodity."[19] In a July 1987 interpretation, the CFTC staff stated that certain risk management transactions, including anticipatory hedging transactions to limit balance sheet risk, should be treated as *bona fide* hedging.[20] In that same release, the staff noted that "many business firms calculate their price risk exposure, less on the basis of risk related to a single transaction and more on the basis of net risk related to changes in the values reflected on balance sheets. Such [balance sheet and certain

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[19] 7 U.S.C. §6a(a)(1).

[20] Clarification of Certain Aspects of the Hedging Definition, 52 Fed. Reg. 27195, 27196 (July, 20, 1987) (discussing amendments to Regulation 1.3(z), which were intended to clarify that balance sheet hedging, as well as certain other risk-reducing strategies, may be treated as *bona fide* hedging).

other risk-reducing trading strategies] now represent an important class of hedging use of these active futures markets."[21]

In a subsequent September 1987 interpretation, the CFTC staff identified that such risk-management transactions do not create "excessive speculation which causes unreasonable or unwarranted changes in commodity prices."[22] In that interpretation, the staff described cash equitization as follows:

> In order to illustrate more precisely the types of positions that could be considered for exemptions from speculative limits by exchanges under a risk-management classification, consider a pension fund that has received new monies from fund contributors. The fund's manager must decide how to allocate such contributions among a myriad of investment alternatives. The manager may believe that the stock market as a whole offers favorable short-term return prospects but may be undecided with respect to the individual stocks to be purchased or, perhaps, whether over the longer run the stock investment should be made. In order to obtain immediate stock market exposure, the manager invests the majority of the new funds in short-term money market instruments (e.g., Treasury bills) and the remainder in long stock index futures contracts. To the extent that the underlying value of the stock index futures position does not exceed the value of the money market investment and the funds used to margin the futures position, the fund manager has effectively created a synthetic stock position in the amount of the new funds.[23]

The CFTC staff went on to state that, "[i]f the fund manager intends to convert the new funds into actual stock purchases, the position currently would be eligible for exemption from speculative limits as a hedge—in effect an anticipatory hedge."[24] The staff contrasted this strategy with one

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[21] *Id.* (citation omitted).

[22] Risk Management Exemptions From Speculative Position Limits Approved Under Commission Regulation 1.61, 52 Fed. Reg. 34633, 34634 (Sept. 14, 1987).

[23] *Id.*, at 34635.

[24] *Id.*

in which a fund manager does not intend to replace the synthetic position with actual stocks, labeling this latter strategy as one of taking a risk management position.

The mutual fund industry has largely interpreted the CFTC's position with regard to anticipatory hedging transactions to mean funds may engage in cash equitization transactions as *bona fide* hedging. We recommend that the CFTC provide guidance upholding the inclusion of anticipatory hedging transactions and cash equitization transactions in the definition of *bona fide* hedging, consistent with its prior interpretive guidance and positions.

Technical Changes

In the final Regulation 4.5(c)(2)(iii)(A) and (B), there are minor distinctions between the references to positions in commodity futures or commodity options contracts, or swaps solely for *bona fide* hedging purposes within the meaning and intent of Regulations 1.3(z)(1) and 151.5.[25] The distinctions suggest that the exclusion for *bona fide* hedging in Regulation 4.5(c)(2)(iii)(A) is limited to swaps and that the exclusion in (B) is not. We recommend that the CFTC provide guidance explaining whether the provisions should be treated as having the same effect or explain the reasoning for and meaning of these distinctions.

Regulation 4.13(a)(3)

Regulation 4.13(a)(3) provides an exemption from registration as a CPO for operators of pools that have limited use of commodity interests and are only offered to limited categories of persons, including: (i) accredited investors; (ii) trusts formed by accredited investors; (iii) knowledgeable employees; (iv) qualified eligible persons ("**QEPs**") as defined in Subsection (a)(2)(viii)(A) of CFTC Regulation 4.7 ("**Regulation 4.7**") (*e.g.*, principals and certain employees and affiliates of

[25] Regulation 4.5(c)(2)(iii)(A) refers to "commodity futures or commodity options contracts, or swaps which do not come within the meaning and intent of Rules 1.3(z)(1) and 151.5," whereas Regulation 4.5(c)(2)(iii)(B) refers to "commodity futures, commodity options contracts, or swaps positions not used solely for *bona fide* hedging purposes within the meaning and intent of Rules 1.3(z)(1) and 151.5." Adopting Release at 11283.

the CPO or investment adviser of the exempt pool); and (v) persons eligible to claim an exemption under Regulation 4.13(a)(4), which is being rescinded. Prior to the adoption of the Final Rules, Regulation 4.13(a)(4) permitted sales to any natural person QEPs as defined in Regulation 4.7(a)(2) (a broader group than those permitted under (iv) above), which includes "Non-United States persons" (among others) under Regulation 4.7(a)(2)(xi). U.S.-based operators of non-U.S. commodity pools that sold interests in such pools exclusively to Non-United States persons were able to claim an exemption from registration as a CPO under Regulation 4.13(a)(4), regardless of whether such pools invested in U.S. commodity interests. Because the Final Rules rescinded Regulation 4.13(a)(4), and Regulation 4.13(a)(3) does not include Non-United States persons as eligible investors in a Regulation 4.13(a)(3) pool, in addition to other changes to the CFTC's rules, a U.S.-based operator of such a pool that transacts in U.S. commodity interests and/or with U.S. swap counterparties would not be able to rely on Regulation 4.13(a)(3) absent further changes.

The Adopting Release states that "the Commission has determined to retain the *de minimis* exemption currently set forth in [Regulation 4.13(a)(3)] without modification." The limitation on the Non-United States person QEPs permitted to participate in a pool relying on Regulation 4.13(a)(3) was not referenced in the Adopting Release and we assume is an oversight. The CFTC also has not identified any compelling interest in protecting Non-United States persons under Regulation 4.13(a)(3), and we believe there is no compelling reason to regulate such operators as registered CPOs. We recommend that the CFTC amend Part 4 to provide a complete exemption for the operators such pools or at least amend Regulation 4.13(a)(3)(iii) to include the substantive definitions of prior Regulation 4.13(a)(4), including all QEPs and particularly Non-United States persons as eligible investors in a pool operated in reliance on Regulation 4.13(a)(3).

Issues with the Trading Limits and Valuation of Commodity Interests

Each of Regulation 4.5, 4.12, and 4.13(a)(3) provides an exclusion or exemption (as applicable) from registration as a CPO based on the pool conducting limited commodity interest trading activity in accordance with the limits set forth in each regulation. Under Regulation 4.5 and

Regulation 4.13(a)(3), the Trading Limits are based on initial margin, option premiums, and required minimum security deposit for retail forex transactions (the security deposit provision applies to Regulation 4.13(a)(3) only) as a percentage of the *liquidation value of the pool's portfolio* (*i.e.*, net asset value), whereas the limits under Regulation 4.12 are based on initial margin, option premiums, and required minimum security deposit for retail forex transactions as a percentage of the *fair market value of the pool's assets* (*i.e.*, total asset value). Regulation 4.5 mirrors the similar limits that were in place under Regulation 4.5 as in effect prior to 2003, except that, prior to 1993, Regulation 4.5 calculated its Trading Limits by reference to the *fair market value of an entity's assets*.[26] It appears that these are materially different denominators. In addition, Regulations 4.5 and 4.13(a)(3) also provide a second alternative trading limit based on aggregate net notional value of commodity interest positions as a percentage of the *liquidation value of the pool's portfolio*, while Regulation 4.12 does not provide a second alternative trading limit. We recommend that the CFTC conform the Trading Limits criteria in Regulations 4.5, 4.12, and 4.13(a)(3), including the same denominator and add the 100% Trading Limit and minimum security deposit for retail forex transactions, or provide guidance explaining the reasons for the distinctions.

Both Regulations 4.5 and 4.13(a)(3) state that the notional value of any cleared swap will be calculated "by the value as determined consistent with the terms of part 45 of the [CFTC's] regulations." Part 45 of the CFTC's regulations does not define notional amounts other than stating that "notional quantity will be defined as the amount of the underlying commodity that is used to calculate periodic settlement payments during the life of the swap." We recommend that

[26] In changing the Regulation 4.5 Trading Limits to reference liquidation value of the pool's portfolio rather than fair market value of the pool's assets, the CFTC stated that "[t]he five percent margin/premium constraint also removes most leverage from commodity futures or option positions assumed by a qualifying entity since in the final rule it will be calculated in relation to the liquidation value of an entity's portfolio (sometimes referred to as the net asset value). The five percent calculation thus cannot be based on the full value of stocks or bonds purchased for the qualifying entity on margin, for example—the liquidation value of the entity's portfolio is net of the amount borrowed." *See* 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).

the CFTC provide guidance as to what in Part 45 would guide the valuation of the notional amount for cleared swaps, which we believe should be the notional amount reportable under the new CFTC rules. Similar guidance is necessary for uncleared swaps, which we believe should be the notional value amount specified in the relevant contract.

Both Regulations 4.5(c)(2)(iii)(B)(2) and 4.13(a)(3)(ii)(B)(2) provide that an excluded or exempt CPO (as applicable) may net cleared swaps "where appropriate." We recommend that the CFTC provide guidance on the meaning of those words and when the CFTC would deem netting in the context of calculating the notional value of cleared swaps to be appropriate. Similar guidance is necessary for uncleared swaps.

Prior Regulation 4.13(a)(3) permitted an exempt pool to "net contracts with the same underlying commodity," which appears to have permitted netting of all types of contracts. However, amended Regulations 4.5 and 4.13(a)(3) only permit netting of "futures contracts with the same underlying commodity" and swaps. We see no operational reason why option contracts should not be permitted to be netted for purposes of calculating notional value. We recommend that the CFTC amend the Final Rules to include options under the netting provisions or provide guidance explaining the reasons for this distinction.

Compliance Timing for Trading Limits

The Final Rules do not consistently specify when CPOs must measure compliance with the Trading Limits. Regulation 4.5(c)(2)(iii)(B) provides that compliance with the 100% Trading Limit is to be "determined at the time the position was established," but there is no explicit guideline for when to calculate compliance with the 5% Trading Limit or the Trading Limits in Regulation 4.12; and Regulation 4.13(a)(3) provides that the Trading Limits must be complied with "[a]t all times."

The CFTC should tie the assessment of whether a fund meets the Trading Limits requirements to the point in time at which the fund makes an investment in a commodity interest or an underlying

fund. A requirement that funds comply with the Trading Limits *at all times* (or on a real-time basis) is not realistic, and moreover could result in inadvertent and temporary non-compliance based on a variety of factors and conditions. In addition, such a requirement could force fund managers to exit positions at times when it would be detrimental to the fund. Measuring compliance at the time of purchase is consistent with mutual fund diversification and fund naming requirements under the 1940 Act and Rule 35d-1 under the 1940 Act.[27] We recommend that the CFTC provide clarity regarding when a CPO must measure compliance.

Additionally, we recommend that the CFTC provide a reasonable window for corrective action by a CPO that determines a fund that it operates is not in compliance with the applicable Trading Limits. This is particularly important for a CPO of a mutual fund-of-funds, which does not have control over the portfolio assets of its underlying funds and cannot predict market changes with perfect accuracy and timing. We recommend that the CFTC provide guidance as to whether there is an appropriate time in which an excluded or exempted CPO may rectify violations of the applicable Trading Limits under Regulations 4.5, 4.12, and 4.13(a)(3).

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[27] Section 5(b) of the 1940 Act requires that, for a mutual fund to qualify as "diversified," it must hold at least 75% of its total assets in cash and cash items (including receivables), government securities, securities of other investment companies, and other securities limited in respect of any one issuer to an amount not greater in value than 5% of the value of the total assets of such mutual fund and to not more than 10% of the outstanding voting securities of such issuer. *See* 15 U.S.C. § 80a-5(b). Section 5(c) of the 1940 Act provides that such diversification is tested at the time the mutual fund acquires assets and that if, subsequent to the acquisition, the nature of the mutual fund or its investments changes such that the fund no longer meets the requirements of Section 5(b), the mutual fund will not lose its diversified status "so long as any such discrepancy existing immediately after its acquisition of any security or other property is neither wholly nor partly the result of such acquisition." *See* 15 U.S.C. § 80a-5(c). Additionally, Rule 35d-1 under the 1940 Act, Investment Company Names, requires that a mutual fund's name not be materially misleading, and therefore if a fund's name would lead investors to believe the fund invests in a certain industry, type of investment, or geographic region, the fund must adopt a policy to invest, under normal circumstances, at least 80% of the value of its assets in investments that are consistent with the investment strategy suggested by the fund's name. This 80% test is also applied at the time the fund invests in securities. Funds are not required to sell assets if they become non-compliant subsequent to the purchase of assets in order to restore compliance, although funds are obligated to invest going forward in a way that would bring them back into compliance. *See* Rel. No. IC-24828 (Jan. 17, 2001); Rel. No. IC-17452 (Apr. 23, 1990).

Forms CPO-PQR and CTA-PR

Regulation 4.27 requires all registered CPOs and CTAs to file CFTC Forms CPO-PQR and CTA-PR (respectively) to allow the CFTC to provide systemic risk information to the Financial Stability Oversight Council ("**FSOC**") and other regulators and conduct its own oversight role.

The CFTC's position, stated elsewhere in the Adopting Release, that CFCs[28] wholly-owned by mutual funds and used for trading commodity interests are commodity pools that should be subject to regulation as such appears to indicate that a CPO to a mutual fund investing in a CFC would be required to report the mutual fund and the CFC as separate commodity pools on Form CPO-PQR. However, the CFTC stated that its purpose in requiring submission of Form CPO-PQR by entities that are dually registered with the CFTC and SEC is to "assess the risk posed by such investment vehicles to derivatives markets and the broader financial system." Further, Form CPO-PQR Instruction 4 provides that a CPO may disregard any pool's equity investments in other pools, and Form CPO-PQR Instruction 3 provides that a CPO must report any "master-feeder arrangements" and "parallel managed accounts" "as if each were an individual pool, but not parallel pools," while assets held in parallel managed accounts "should be treated as assets of the pools with which they are aggregated."

Form CPO-PQR does not provide explicit guidance with regard to a mutual fund's investment in a CFC—*i.e.*, whether the fund's CPO that also serves as CPO to its wholly-owned CFC can aggregate the assets of the CFC with those of the mutual fund and report them on the mutual fund's Form CPO-PQR as a single pool or instead report the two pools separately. As a result, we recommend that the CFTC provide guidance whether it would be appropriate to permit the mutual fund's CPO to consolidate the two entities for purposes of reporting on Form CPO-PQR to avoid redundancy and increased costs.

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[28] For a full description of mutual fund investments in CFCs, see Section II(A)(7) of the Adopting Release.

In addition, if an investment adviser has to register as a CPO, it is not completely clear whether that investment adviser-CPO must report on Form CPO-PQR (i) all funds managed by that CPO or (ii) only those funds whose activities result in CPO registration. It is also not completely clear whether a registered CPO must report any commodity pools with respect to which it has claimed an exemption under Regulation 4.13(a)(3). A plain reading of the reporting rules suggests that only those funds whose activities result in the CPO registration requirement need to be reported (*i.e.*, not funds relying on Regulation 4.5 or 4.13(a)(3)). We recommend that the CFTC confirm these points.

Additionally, we recommend that the CFTC confirm that, for purposes of determining the reporting thresholds on Form CPO-PQR, the term "affiliates" is intended only to encompass those affiliates that are CFTC registrants, and that other affiliated entities of a CPO should not be considered.

CFCs; Directors and Trustees

Operators of CFCs, which many mutual funds utilize for purposes of engaging in commodity interest trading, generally have been able to claim relief from registration as a CPO under Regulation 4.13(a)(4) because interests in the CFC are exempt from registration under the Securities Act of 1933 as amended, such interests are offered and sold without marketing to the public in the United States, and the CFC's sole participant is a mutual fund which qualifies as a QEP.

The CFTC did not provide guidance in the Adopting Release as to which entity should be required to register as the CPO of the CFC. However, the CFTC staff has in the past provided no-action relief to allow a private fund board of directors or trustees to delegate CPO responsibilities to the fund's investment adviser so long as the directors or trustees assumed joint and several liability for any act of the CPO in violation of its duties under the CEA and CFTC regulations. However, based on the reasoning set forth in the Adopting Release regarding the CFTC's conclusion that a mutual fund's investment adviser is the appropriate entity to register as

CPO as opposed to members of its board of directors or trustees, and the fact that individual directors and trustees are and will be reluctant to serve in those capacities due to potential personal liability, we recommend that the CFTC provide that the investment adviser to a CFC (which may or may not be the same investment adviser or sub-adviser to the upper-level mutual fund or an affiliate thereof) likewise be the entity required to register as the CPO of the CFC, and not the directors or trustees themselves. We likewise recommend that this same treatment be extended to all private fund and non-U.S. fund-commodity pool directors and trustees.

Additionally, we recommend that the CFTC dispense with the notion of directors or trustees of any corporate, trust, or other entity (whether a CFC or any other private or non-U.S. fund-commodity pool) being deemed to be CPOs and entitled to delegate CPO responsibilities only so long as they retain joint and several liability for violations of the CEA and the CFTC regulations applicable to CPOs. This is consistent with the CFTC's conclusions on individual mutual fund director and trustee accountability and liability, and will not have the unintended result of discouraging individuals from serving in such capacities. Moreover, a registered CPO will be appointed to carry out the required functions and will be responsible and liable for compliance. If the CFTC will not provide such guidance and relief generally, we recommend that the CFTC at least provide that the directors and trustees of a CFC or other private or non-U.S. fund-commodity pool that are independent from the pool's sponsor or investment adviser be able to receive such relief.

Separately, there is no compelling reason why operators of CFCs that register as CPOs should be required to provide their sole investors (*i.e.*, one or more mutual funds), with the required CFTC disclosure document or otherwise comply with the Part 4 regulations. We recommend that the CFTC provide guidance that it is unnecessary for CFCs to provide mutual funds with disclosure documents or otherwise comply with the Part 4 regulations.

AP Registration

CFTC Regulation 3.12 ("**Regulation 3.12**")[29] under the CEA requires the registration of "associated persons" of CPOs and other CFTC registrants with the NFA unless an exemption from registration is available. As a result, the sales staff of any mutual fund that does not qualify for exclusion from the definition of CPO under Regulation 4.5 will need to register associated persons of the fund's investment adviser-CPO with the NFA unless an exemption is available. Regulation 3.12(h)(1)(ii) provides an exemption from registration for persons "engaged in the solicitation of funds, securities, or property for a participation in a commodity pool, or the supervision of any person or persons so engaged, pursuant to registration with [the Financial Industry Regulatory Authority (f/k/a the National Association of Securities Dealers) ("**FINRA**")] as a registered representative, registered principal, limited representative or limited principal, and that person does not engage in any other activity subject to regulation by the CFTC." FINRA requires member broker-dealers' staff that sell mutual fund shares to take and pass the FINRA Investment Company/Variable Contracts Products Limited Representative Qualification Examination (Series 6).

We recommend that the CFTC confirm that a Series 6 FINRA registered limited representative will qualify for the exemption under Regulation 3.12(h)(1)(ii) with respect to the sale of shares of a mutual fund that does not qualify under the CPO exclusion in Regulation 4.5. We also recommend that the CFTC provide guidance as to what other mutual fund investment adviser-CPO personnel would be required to register as an associated person of the investment adviser-CPO (*i.e.*, only employees of the adviser) and what examination they must take, including whether such examination would be the Series 31 examination and not the Series 3 examination.

Additionally, we recommend that the CFTC confirm that Series 7 and 6 registered representatives of a FINRA member firm may receive trail commissions/fees generated by an associated person

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[29] 17 C.F.R. § 3.12.

within the same firm without registering as associated persons of a mutual fund's investment adviser-CPO.

Other

Prior to adopting the Final Rules, the CFTC provided relief to registered CPOs from disclosure, reporting, and certain recordkeeping requirements in connection with the operation of non-U.S. commodity pools.[30] We believe there is no compelling reason to regulate such pool operators as registered CPOs. We recommend that the CFTC confirm that the relief to registered CPOs under CFTC Advisory 18-96 is still available.

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[30] Offshore Commodity Pools, Relief for Certain Registered CPOs from Rules 4.21, 4.22 and 4.23(a)(10) and (a)(11) and from the Location of Books and Records Requirement of Rule 4.23, CFTC Advisory 18-96 (April 11, 1996) ("**CFTC Advisory 18-96**").

Thank you for considering our comments and requests for additional guidance on these important topics. If you have questions or if we can provide additional information that may assist the CFTC and its staff, please contact Holland West at 212.698.3527 or holland.west@dechert.com, Matthew Kerfoot at 212.641.5694 or matthew.kerfoot@dechert.com, Philip Hinkle at 202.261.3460 or philip.hinkle@dechert.com, Audrey Wagner at 202.261.3365 audrey.wagner@dechert.com, or Andrea Baron at 202.261.3444 or andrea.baron@dechert.com.

Respectfully submitted,

/s/ M. Holland West

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The Honorable Scott D. O'Malia, Commissioner
The Honorable Jill E. Sommers, Commissioner
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