NFA NATIONAL FUTURES ASSOCIATION

August 18, 2010

Via E-Mail and Overnight Mail

Mr. David Stawick
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st, N.W.
Washington, DC 20581

Re: Petition for Rulemaking to Amend CFTC Regulation 4.5

Dear Mr. Stawick:

National Futures Association (NFA) respectfully petitions the Commission under CFTC Regulation 13.2 to amend CFTC Regulation 4.5, which provides an exclusion from the definition of the term "commodity pool operator" for otherwise regulated persons operating certain qualifying entities.[1] Prior to 2003, persons claiming this exclusion had to file a notice of eligibility pursuant to CFTC Regulation 4.5(c) and represent, in part, that the person will operate the qualifying entity such that it (1) will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures or commodity options markets; and (2) will use commodity futures or commodity options contracts solely for *bona fide* hedging purposes and, with respect to positions held for non-*bona fide* hedging purposes the aggregate initial margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into.

For the reasons set forth below, we request that the CFTC amend Regulation 4.5(c) to restore operating restrictions on registered investment companies that are substantially similar to those in effect prior to 2003. The information required by CFTC Regulation 13.2 follows:

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[1] NFA withdrew its June 29, 2010 Petition for Rulemaking to Amend CFTC Regulation 4.5 by separate letter dated August 18, 2010.

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I. Text of Proposed Rule Amendments [additions are <u>underlined</u>]

Part 4 – COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS

4.5 Exclusion from the definition of the term "commodity pool operator."

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(c)

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(2) The notice of eligibility must contain representations that such person will operate the qualifying entity specified therein in a manner such that the qualifying entity:

(i) Will disclose in writing to each participant, whether existing or prospective, that the qualifying entity is operated by a person who has claimed an exclusion from the definition of the term "commodity pool operator" under the Act and, therefore, who is not subject to registration or regulation as a pool operator under the Act; *Provided*, that such disclosure is made in accordance with the requirements of any other federal or state regulatory authority to which the qualifying entity is subject. The qualifying entity may make such disclosure by including the information in any document that its other federal or state regulator requires to be furnished routinely to participants or, if no such document is furnished routinely, the information may be disclosed in any instrument establishing the entity's investment policies and objectives that the other regulator requires to be made available to the entity's participants; and

(ii) Will submit to such special calls as the Commission may make to require the qualifying entity to demonstrate compliance with the provision of this § 4.5(c);

<u>(iii)</u> <u>Furthermore, if the person claiming the exclusion is an investment company registered under the Investment Company Act of 1940, then the notice of</u>

eligibility must also contain representations that such person will operate the qualifying entity as described in § 4.5(b)(1) in a manner such that the qualifying entity:

(a) Will use commodity futures or commodity options contracts solely for bona fide hedging purposes within the meaning and intent of § 1.3(z)(1); *Provided, however,* That in addition, with respect to positions in commodity futures or commodity option contracts that may be held by a qualifying entity only which do not come within the meaning and intent of § 1.3(z)(1), a qualifying entity may represent that the aggregate initial margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into; and, *Provided further,* That in the case of an option that is in-the-money at the time of purchase, the in-the-money amount as defined in § 190.01(x) may be excluded in computing such 5 percent;

(b) Will not be, and has not been, marketing participations to the public as or in 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;

Provided further, however, That the making of such representations shall not be deemed a substitute for compliance with any criteria applicable to commodity futures or commodity options trading established by any regulator to which such person or qualifying entity is subject.

II. Nature of NFA's Interest

As you know, NFA is a futures association registered under Section 17 of the Commodity Exchange Act. One of NFA's primary purposes is to ensure the protection of customers participating in the commodity futures markets. Recently, NFA has become aware of at least three entities filing for exclusions under Regulation 4.5 with respect to registered investment companies that they operate. These mutual funds are marketed to customers, including retail investors, as commodity futures investments and are indirectly invested substantially in derivatives and futures products. In fact, although these funds are structured differently than public commodity pools and conduct the futures trading through a subsidiary for tax and mutual fund regulatory purposes, their aim is the same—targeting retail investors with in some cases minimum investment amounts of as little as $1,000 who want exposure to actively managed futures strategies.

Importantly, as noted above, these three funds invest in commodity futures instruments and/or other managed futures trading programs through a wholly-owned and controlled subsidiary. The fund invests up to 25% of its total assets in this subsidiary, and by leveraging assets at a 4 to 1 ratio, a fund is able to achieve a managed futures exposure equal to the full net value of the fund.

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 or are 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.

III. Supporting Arguments

CFTC Regulation 4.5 currently makes available to eligible persons an exclusion from the definition of CPO with respect to the operation of certain qualifying entities, including registered investment companies, that would otherwise constitute commodity pools but that are already subject to extensive federal and/or state operating requirements. Prior to 2003, eligible persons claiming this exclusion were required to represent that commodity futures and option contracts were used solely for *bona fide* hedging purposes, and that for positions in commodity futures and option contracts that were not used for *bona fide* hedging purposes, the aggregate initial margin and premiums do not exceed 5% of the liquidating value of the qualifying entity's portfolio after taking into account unrealized profits and losses. In addition, eligible persons were required to represent that the qualifying entity will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures or commodity options markets.

In March 2003, the Commission proposed amendments to Regulation 4.5 to eliminate the limitation on non-hedge trading. At the same time, the Commission proposed formally adopting CFTC Regulation 4.13(a)(4) to provide an additional exemption from CPO registration based *solely* on a pool participant's purported sophistication, without any requirement that the pool operator must be subject to another regulatory scheme and without any restriction whatsoever on the purpose and scope of the pool's commodity interest trading. The Commission further stated that "since the eligible persons and qualifying entities of Rule 4.5 are, as stated in the title of the rule, 'otherwise regulated,' the Commission believes that, like the unregulated CPOs for whom it is proposing relief below, these persons and entities may not need to be subject to any commodity interest trading criteria to qualify for relief under Rule 4.5."[2]

At this time, the Commission also stated its view that Regulation 4.5's "no-marketing" restriction should remain in place. The Commission noted that eligible persons should remain prohibited from marketing a qualifying entity as a commodity pool or otherwise as a vehicle to trade commodity interests and indicated that this restriction was necessary because members of the retail public may participate in the trading vehicles subject to a Regulation 4.5 exclusion. The Commission nonetheless requested comment on the merits of maintaining this marketing prohibition.[3]

By letter dated May 1, 2003 to the CFTC, NFA supported maintaining Regulation 4.5's "no marketing" restriction. In particular, NFA stated that "current and proposed Rule 4.5 both provide that the exclusion is not available if the vehicles are marketed as commodity pools. Since Rule 4.5 is an exclusion rather than an exemption, the anti-fraud provisions of Section 4(o) of the CEA do not apply. Investments in these vehicles can be - and often are - sold to unsophisticated customers. While the sale of these investment vehicles is subject to the anti-fraud provisions in other statutes, unsophisticated customers should also have the benefit of Section 4(o) if the investment is marketed as a commodity pool. Therefore, we agree

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[2] See 68 Fed. Reg. 12622,12626 (March 17, 2003).
[3] See Id.

that the exclusion should not be available if the vehicles are marketed as commodity pools." NFA felt that with this "no-marketing" restriction in place, it made sense to eliminate the limitation on non-hedge commodity trading due to certain concerns regarding margin levels expressed at that time.

In August 2003, after receiving comments that supported eliminating both the limitation on non-hedge commodity trading and the prohibition on marketing these qualifying entities, the Commission adopted amendments to Regulation 4.5 to eliminate both these provisions. In doing so, the Commission stated that "one commenter agreed with the proposed retention of the 'no marketing' criterion (and with the Commission's rationale therefore) but several commenters disagreed with it. The Commission noted, in part, that these commenters claimed that, in the absence of any trading restriction, the "otherwise regulated nature" of the qualifying entities specified in Regulation 4.5 would provide adequate customer protection.[4]

Over the past several months, at least three entities that previously filed notices for exclusions under Regulation 4.5 with respect to certain registered investment companies launched these mutual funds. These mutual funds are marketed to customers, including retail investors, as commodity futures investments and are indirectly invested via a subsidiary structure substantially in derivatives and futures products. Customers may use an electronic brokerage account to trade one of these mutual funds, which are sold by broker/dealers on internet platforms in which retail investors only need to point and click to either buy or redeem shares in a fund that offers exposure to an actively managed futures product.

NFA staff has reviewed the prospectuses and promotional material prepared for these funds.[5] One fund's prospectus indicates that it pursues its investment strategy by mainly investing in a combination of exchange traded futures

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[4] See 68 Fed. Reg. 47221, 47223 (August 8, 2003).
[5] See MutualHedge Frontier Legends Fund—http://mutualhedge.com/default.aspx;
AQR Fund—http://www.aqrfunds.com/
Our_Funds/Individual/FundID_12/Overview/Managed_Futures_Strategy_Fund.fs;and Highbridge Fund—https://www.jpmorganfunds.com/cm/Satellite?pagename=jpmfVanityWrapper&UserFriendlyURL=fundoverview&cusip=48121A696

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and options contracts, forward contracts, swaps, and other over the counter derivatives and fixed income securities, often referred to as a "managed futures strategy."[6]

This fund's promotional material indicates that the fund's inception date was December 31, 2009, and the fund has a minimum investment amount of $2,500 (subsequent investments of $500) and offers two share classes, A and C. Class A has a maximum sales charge of 5.75% and a net expense ratio of 2.20% and Class C has no sales charge but a net expense ratio of 2.95%.[7] The fund's promotional material also states that the fund is "A Pioneering Managed Futures Investment" that is accessible, comprehensive, innovative, and has proven management.[8] The material also specifically notes that the fund has a "lower cost structure than most retail managed futures funds" and is "the first mutual fund to generate managed futures returns through net-long, actively managed CTAs." The fund's assets are traded pursuant to five managed futures trading programs. In particular, the fund's prospectus states that the subsidiary's investment adviser (which is also the fund's adviser) expects to invest the assets of the subsidiary in a manner designed to provide exposure to five global macro programs.

In adopting the 2003 changes to Regulation 4.5, the CFTC eliminated the prior "no-marketing" restriction and did not place any qualification standards on the type of customers who may invest in a qualifying entity. Without these types of operating

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[6] A second fund's prospectus states that in order to pursue its investment objective, the fund invests in futures contracts and futures-related instruments including, but not limited to, equity index futures, currency forwards, commodity futures, swaps on commodity futures, fixed income futures, bond futures and swaps on bond futures (collectively, the Instruments) either by investing directly in those Instruments, or indirectly by investing in a subsidiary that invests in those Instruments. The third fund's prospectus states that the fund seeks to achieve its objective by investing in a diversified portfolio of commodity-linked derivatives and fixed income securities. The prospectus additionally states that the fund invests in commodity-linked derivative instruments, such as commodity-linked notes, swap agreements, commodity options, futures and options on futures that provide exposure to the investment returns of the commodities markets without investing directly in physical commodities.

[7] The other two funds also commenced in January 2010 and these also have various share classes with minimum investment amounts ranging from $5,000 to $1 million and $1,000 to $1 million, respectively.

[8] A second fund's Fact Sheet makes similar statements and indicates that "The Fund delivers an active long/short Managed Futures strategy in a mutual fund vehicle." The fund's investment objective states the fund "seeks to generate positive absolute returns."

restrictions, these mutual funds are marketed and sold to customers, including retail investors, who may be unsophisticated in commodity futures investments. NFA believes that any commodity futures investment that is marketed to retail customers as a commodity pool or otherwise as or in a vehicle for trading or investing in (or otherwise seeking exposure to) the commodity futures or commodity options markets should be subject to the regulatory requirements and protections contained in the CFTC's Part 4 regulations.

In reviewing these funds' prospectuses, NFA found that the offering material omits substantial disclosures that would otherwise be mandated by Part 4. Among other things, the prospectuses do not include detailed information about the fund's futures commission merchants and potential conflicts of interest, and performance information for the fund (assuming it has three months performance) or other funds operated by the investment adviser. Additionally, to the extent the funds' prospectuses state that the fund and/or subsidiary will invest in other actively managed futures trading programs, the prospectuses provide little information about these managed futures trading programs, these programs' fee structures, and the past performance results of their trading managers.

NFA also has customer protection concerns relating to these mutual funds' use of a wholly-owned and controlled subsidiary to invest in commodity futures transactions on behalf of the fund. NFA understands from reviewing some of these funds' prospectuses that the funds' investment in a subsidiary is intended to provide the funds with exposure to futures and commodities in a manner consistent with the limitations of the federal tax requirements in Sub-chapter M of the IRS Code. Sub-chapter M requires, in part, that at least 90% of a fund's income be derived from securities or derived with respect to its business of investment in securities (i.e., qualifying income). The funds rely upon IRS private letter rulings to other mutual funds, which indicate income from a fund's investment in a subsidiary will constitute qualifying income.

However, while these funds' offering materials indicate that the subsidiaries are subject to certain investment restrictions applicable to the funds themselves, these subsidiaries are neither commodity pools regulated by the CFTC and NFA nor registered investment companies. Additionally, the prospectuses make clear that the subsidiaries are not subject to the Investment Company Act of 1940's customer protection regime. The vast majority of the regulated funds' holdings appear to be money market instruments to serve as collateral for the subsidiaries' derivatives positions; yet, the subsidiaries' daily operations, including their actual derivatives positions (including the positions' leverage amounts) and fees charged are not entirely transparent.

Given these funds' offerings, NFA proposes the aforementioned amendments to Regulation 4.5 since we believe the premises underlying the Commission's elimination in 2003 of the "no-marketing" and "five-percent trading test" limitations as applied to registered investment companies may no longer be valid. To the extent the Commission used proposed Regulation 4.13(a)(4) as a rationale to eliminate the "five-percent trading test", NFA believes that the Commission should review whether this rationale remains appropriate in light of these actively managed retail futures funds.[9]

NFA believes at this time that Regulation 4.13(a)(4)'s exemption from CPO registration does not support the 2003 elimination of the "five-percent trading test." Specifically, although Regulation 4.13(a)(4) does not contain any restriction on the purpose or scope of a pool's commodity interest trading, we believe a critical distinction between a Regulation 4.5 qualifying entity and a Regulation 4.13(a)(4) pool is the qualifications of the fund participants[10]—Regulation 4.13(a)(4)(ii)(A) requires every natural person pool participant to be a "qualified eligible person" as defined in Commission Regulation 4.7(a)(2). In contrast, Regulation 4.5 has no qualification requirement for customers who may invest in a qualifying entity, including a registered investment company. Moreover, NFA strongly believes that in circumstances in which no qualification requirement exists for fund participants, then NFA and the CFTC should

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[9] NFA recognizes that registered investment companies may need to engage in futures transactions for bona fide hedging purposes and believes they should be permitted to engage a *de minimis* amount of speculative futures trading without the necessity to be registered with and regulated by the CFTC.

[10] Another distinction is interests in Regulation 4.13(a)(4) pools are exempt from registration under the Securities Act of 1933 while Regulation 4.5 qualifying entities are operated by otherwise regulated persons. For the reasons explained in this letter, however, NFA believes that to the extent that the Commission's 2003 amendments to Regulation 4.5 were, in part, premised on the "otherwise regulated nature" of the qualifying entities, this premise may no longer be valid.

have regulatory oversight of collective investment vehicles that engage in more than a *de minimis* amount of futures trading. [11]

Additionally, to the extent that the Commission's 2003 amendments to Regulation 4.5 were, in part, premised on the "otherwise regulated nature" of the qualifying entities, this premise may no longer be valid. As noted above, despite the fact that these registered investment companies are marketed to retail customers as an actively managed futures fund, they are not subject to customer protection rules entirely comparable to the CFTC's Part 4 Regulations and NFA's Compliance Rules. NFA believes that a registered investment company that is marketed, in part, to unsophisticated retail customers as a commodity pool or otherwise as or in a vehicle for trading in (or otherwise seeking exposure to) the commodity futures or commodity options markets or that engages in more than a *de minimis* amount of non-hedge futures trading should be subject to the CFTC's Part 4 regulatory requirements and protections, and the oversight of the CFTC and NFA who have the experience and expertise in regulating managed retail futures products. The CFTC alone has the Congressional mandate to regulate retail managed futures trading and products, and over the years has developed the specialized body of skill and knowledge necessary to fulfill this mandate.

Additionally, NFA is deeply concerned that a number of CPOs who currently operate public pools will avail themselves of this alternative registered investment company structure. Given our concern with this registered investment company structure and the lack of adequate retail customer protections in some areas comparable to those afforded prospective investors in a public commodity pool subject to Part 4, NFA does not believe that retail futures customers would be served well if this migration were to occur.

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[11] NFA notes that Commission Regulation 4.13(a)(3) provides an exemption from CPO registration, which requires a pool to meet one of two tests with respect to its commodity interest positions, including positions in security futures products, whether entered into for bona fide hedging purposes or otherwise—the aggregate initial margin and premiums required to establish such positions will not exceed 5% of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into or the aggregate net notional value of such positions does not exceed 100% of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into. Moreover, CFTC Regulation 4.13(a)(3)(iii) requires natural person pool participants to at least meet the accredited investor qualification standards.

For these reasons, NFA respectfully requests that the Commission amend Regulation 4.5(c) to require a registered investment company claiming an exclusion from the definition of the term "commodity pool operator" to represent in the notice of eligibility that the qualifying entity (i.e. registered investment company) will be operated such that it (1) will not be, and has not been, marketing participations to the public as or in 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; and (2) will use commodity futures or commodity options contracts solely for bona fide hedging purposes and, with respect to positions that may be held by the qualifying entity only for non-bona fide hedging purposes the aggregate initial margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into.

Lastly, NFA recognizes that, if adopted, the proposed amendments to Regulation 4.5 will impose the same operating restrictions on registered investment companies that were in place prior to 2003. Obviously, since 2003, a number of persons have filed notices of eligibility pursuant to Regulation 4.5(c) on behalf of registered investment companies, and those entities may no longer be eligible for exclusion from CPO registration in the future if the proposed amendments are adopted. Therefore, NFA encourages the Commission to provide adequate time for these registered investment companies to comply with the Commission's applicable regulations or seek the appropriate relief therefrom.

Additionally, to the extent that the Commission has granted operational relief from certain Part 4 Regulations (e.g. disclosure document and reporting and recordkeeping) to exchange traded funds—that are commodity pools organized as Delaware statutory trusts—NFA encourages the CFTC to determine whether it is appropriate to grant similar and/or other relief to public commodity pools and listed pools that may want to continue operating as registered investment companies. If the Commission desires, NFA is willing to participate in discussions in the future with Commission staff to achieve this result, which may necessitate harmonizing CFTC and SEC regulatory requirements.

August 18, 2010

NFA respectfully petitions the Commission to amend Regulations 4.5 as described above.

Very truly yours,

Thomas W. Sexton, III
Senior Vice President
and General Counsel

cc: Via Email:
Honorable Gary Gensler, CFTC Chairman
Honorable Michael Dunn, CFTC Commissioner
Honorable Scott O'Malia, CFTC Commissioner
Honorable Jill E. Sommers, CFTC Commissioner
Honorable Bart Chilton, CFTC Commissioner
Mr. Ananda Radhakrishnan, CFTC Director
Mr. William Penner, CFTC Deputy Director

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