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February 26, 2013

VIA ELECTRONIC MAIL

Mr. Gary Barnett  
Director  
Division of Swap Dealer and Intermediary Oversight  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, NW  
Washington, DC 20581

Re: Compliance with Registration Requirements Under Amended Regulations 4.5 and 4.13(a)(3) by Funds of Funds

Dear Mr. Barnett:

The Investment Company Institute (“ICI”)<sup>1</sup> and the Investment Adviser Association (“IAA”)<sup>2</sup> are submitting this letter to the Division of Swap Dealer and Intermediary Oversight (“Division”) on an issue of critical importance to sponsors/managers of registered investment companies and private funds (each, a “fund”): how the *de minimis* thresholds in Regulations 4.5 and 4.13(a)(3) will be applied to a “fund of funds.” We appreciate the Division’s recognition of this issue’s importance, as evidenced by its current efforts to prepare guidance (“Guidance”) in this area, and its temporary relief regarding the registration obligation for certain fund of funds managers until six months after such Guidance is issued.<sup>3</sup>

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (“ETFs”), and unit investment trusts (“UITs”). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$14.2 trillion and serve over 90 million shareholders. As a result of the CFTC’s recent amendments to Regulation 4.5, many registered investment advisers that advise registered investment companies must register as commodity pool operators (“CPOs”). Although ICI has judicially challenged amended Regulation 4.5, see Complaint, *Investment Company Institute, et al. v. CFTC*, Case No. 1:12-cv-00612 (D.D.C. Apr. 17, 2012), it is committed to assisting its members’ efforts to comply with the amended regulation.

<sup>2</sup> The Investment Adviser Association is a not-for-profit association that represents the interests of investment adviser firms registered with the Securities and Exchange Commission. Founded in 1937, the IAA’s membership consists of more than 550 advisers that collectively manage in excess of \$10 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit our web site: [www.investmentadviser.org](http://www.investmentadviser.org).

<sup>3</sup> CFTC No-Action Letter No. 12-38 (Nov. 29, 2012) (“Letter 12-38”).

In our view, the Division's Guidance should be sufficiently broad to address three significant developments in the last year:

1. The removal of Appendix A ("Former Appendix A")<sup>4</sup> from Part 4 of the Commodity Futures Trading Commission's ("CFTC" or "Commission") regulations, which formerly guided the application of the *de minimis* thresholds to fund of funds managers seeking to rely on Regulation 4.13(a)(3);
2. The application of the *de minimis* thresholds to managers of registered funds of funds, in light of the Commission's amendments to Regulation 4.5; and
3. The fact that some securities in which registered and private funds invest—for example, certain securities issued by securitization vehicles, real estate investment trusts ("REITs") and business development companies ("BDCs") — are now treated as interests in commodity pools.

In this letter, we offer concrete recommendations for how the Guidance can be made flexible and workable for fund of fund managers and still achieve what we understand the Division's objective to be — to exclude from regulation only those managers of funds of funds whose direct and indirect commodity interest trading is below a certain level. Our recommendations are generally consistent with, and seek to achieve the same purposes as, those set forth in previous submissions by the ICI, the IAA, the Managed Funds Association ("MFA") and the Asset Management Group of the Securities Industry and Financial Markets Association ("AMG").<sup>5</sup>

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<sup>4</sup> We note that Former Appendix A was developed by the CFTC as part of its consideration of rulemaking proposals that led, in relevant part, to the Commission's adoption of Regulation 4.13(a)(3). *See Commodity Pool Operators and Commodity Trading Advisors; Exemption from Requirement to Register for CPOs of Certain Pools and CTAs Advising Such Pools*, 67 Fed. Reg. 68785, 68788- 68790 (Nov. 13, 2002) ("2002 ANPR") (discussing, and offering examples of, how the temporary registration no-action relief outlined in the 2002 ANPR would apply to the operator of a "fund of funds" and requesting comments on how relief for fund of funds managers should be addressed in the Commission's proposal); *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors*, 68 Fed. Reg. 12622, 12631 (March 17, 2003) (providing additional guidance in response to commenters' reactions to the examples, and requesting general comment on how to treat funds of funds in the context of CPO registration and Regulation 4.13); *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues*, 68 Fed. Reg. 47221, 47225 (Aug. 8, 2003) ("Regulation 4.13(a)(3) Adopting Release") (adopting Appendix A in order to address concerns and scenarios raised by commenters, and explaining the four principles that guided the Commission's adoption of Appendix A).

<sup>5</sup> *See* submission by the ICI and the IAA to Division staff on July 10, 2012; Letter from AMG to Amanda Olear of the Division staff dated August 15, 2012; Letter from the IAA and the MFA to the CFTC dated November 9, 2012; and Letter from the MFA to the CFTC on December 19, 2012. This letter does not supersede those submissions, but rather attempts to integrate and build upon them. For example, we continue to urge the Division to permit use of combinations of situations from Former Appendix A, such as the ability of funds of funds to invest in a mixture of

To ensure that the Guidance satisfies the Division's objectives without resulting in unintended consequences, we urge the Division to afford fund of funds managers and other members of the public the opportunity to review and comment on the Guidance before it is issued in final form. We note that, since the repeal of Regulation 4.13(a)(4) and the substantial narrowing of Regulation 4.5, investment advisers to registered and private funds have spent considerable time trying to understand how the guidance in Former Appendix A would apply to their wide range of fund structures and investments.<sup>6</sup> This experience with Former Appendix A would inform the comments of fund of funds managers and thus potentially provide the Division with valuable insights as it crafts the Guidance. Fund of funds investors also should have the opportunity to comment on the Guidance, as it would affect the operation of the funds in which they invest.

## **Background**

### 1. What is a Fund of Funds?

The term "fund of funds" traditionally has been used to describe a fund that invests in a number of underlying funds operated by third parties. Today, many registered and private funds invest in some combination of other registered funds and/or private funds. Their managers also may engage sub-advisers to directly manage one or more portions of the fund's assets (each such portion referred to as a "Sub-Advised Sleeve"<sup>7</sup>), with or without some level of direct trading by the manager.

Some funds, on the other hand, are not commonly considered to be "funds of funds." Some of these funds invest a relatively small portion of their assets in one or more underlying funds to gain exposure to an asset class or strategy in a more efficient manner, with a majority of their assets invested directly in individual securities or other investments. In addition, certain funds may now be viewed as funds of funds solely because certain securities in which they invest have been identified by the Division as interests in commodity pools. These include certain securities issued by REITs, securitization vehicles, and BDCs that meet the definition of commodity pool.<sup>8</sup>

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underlying funds operated by registered CPOs and underlying funds that each comply with the *de minimis* limitations.

<sup>6</sup> See answer to question 1 under the heading "Fund-of-funds" in *Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions – CPO/CTA: Amendments to Compliance Obligations (August 2012, as amended)*, which permits managers of funds of funds to rely on Former Appendix A until the Guidance is issued.

<sup>7</sup> For purposes of this letter, a Sub-Advised Sleeve is typically structured as an arrangement where a sub-adviser is retained to provide investment advisory services to a portion of a fund. A Sub-Advised Sleeve could also include a portion of a fund advised by a broker-dealer that provides advisory services ancillary to its brokerage services.

<sup>8</sup> Until recently, these types of entities were not commonly considered "commodity pools" as they were not thought of as pooling assets "for the purpose of trading commodity interests" as required by Section 1a(10) of the

For purposes of this letter, a “FOF” is defined as a fund that (1) invests in one or more investment vehicles that are commodity pools (for example, registered funds,<sup>9</sup> private funds, REITs, securitization vehicles, or BDCs that are, in each case, a commodity pool) and/or (2) has one or more Sub-Advised Sleeves that trade commodity interests.<sup>10</sup> Each such investment vehicle or Sub-Advised Sleeve may be managed by the FOF Manager itself or by an affiliated or unaffiliated investment manager. The sponsor/manager of the FOF is referred to as the “FOF Manager,” the investment vehicle or Sub-Advised Sleeve is referred to as an “Underlying Fund” and the manager/operator of an Underlying Fund is referred to as an “Underlying Manager.” Underlying Funds that are REITs, securitization vehicles, or BDCs and trade commodity interests are referred to as “Non-Traditional Pools.”

## 2. FOF Investor Expectations and Investment Management.

*“True” Funds of Funds.* Investing in a “true” FOF provides the FOF investor with access to professional investment advice in the selection of Underlying Funds and to a more diversified Underlying Fund portfolio. In our experience, persons invest in such FOFs because they want the FOF Manager to select the Underlying Funds in which the FOF will invest.<sup>11</sup> A FOF investor may not have the time or the expertise to select Underlying Funds. FOF investors do not always receive,<sup>12</sup> nor do they generally want to receive, information in offering documents regarding the particular Underlying Funds in which the FOF invests (other than perhaps to a limited extent through investor reporting and in financial statements and other

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Commodity Exchange Act. A BDC can be thought of as more akin to an operating company because the BDC’s manager is required to exercise a controlling influence over a certain portion of the BDC’s assets. *See* Section 55 of the Investment Company Act of 1940 (“Investment Company Act”).

<sup>9</sup> Registered funds include open-end funds (mutual funds), closed-end funds, ETFs, and UITs. Closed-end funds, ETFs, and UITs are often traded in secondary market transactions.

<sup>10</sup> This definition of FOF is generally consistent with the Division’s definitions of “Investor Fund” or “Fund of Funds” in Letter 12-38, except that Letter 12-38 does not expressly address Sub-Advised Sleeves.

<sup>11</sup> Most FOF Managers market their FOFs by explaining how they (1) organize their FOFs (for example, registered or private FOF, diversified or single strategy focused, low or moderate volatility), (2) select the investment strategies in which the FOF will invest (for example, long-short equity, credit, fixed income, distressed debt, special situations, global macro, event driven, convertible arbitrage and managed futures), (3) select the particular Underlying Funds (including conducting legal and operational due diligence) in which the FOF will invest, (4) monitor the Underlying Managers (for example, with respect to strategy implementation and compliance with investment limitations), and (5) determine whether to invest in an Underlying Fund or redeem.

<sup>12</sup> Usually a FOF’s offering documents will provide more information on Underlying Funds when the FOF invests in affiliated Underlying Funds or when the Underlying Funds in which the FOF invests are not expected to change over the life of the FOF.

reports prepared by the FOF Manager or its agent, such as an administrator).<sup>13</sup> Required disclosures also are designed to ensure that FOF investors understand that the Underlying Funds and the allocations to them will change over time. Fundamentally, FOF investors want the FOF Manager to use its expertise to make these investment and allocation decisions and seek to produce returns that are better than the returns that investors could have achieved on their own, after considering the fees and expenses charged by the FOF.

From the FOF Manager's perspective, when the FOF Manager selects Underlying Funds, the FOF Manager is looking for Underlying Funds that the FOF Manager expects will produce higher returns than other underlying funds or investment managers pursuing the same or substantially similar investment strategies. The FOF Manager considers an investment in an Underlying Fund from a variety of perspectives, such as fees and liquidity, performance, legal and operational due diligence, investment strategy and methodology, whether it is an index component, and compatibility with the overall FOF portfolio. FOF Managers are focused on how an Underlying Manager implements its investment strategy to achieve the Underlying Fund's investment objective; the precise extent of commodity interest trading by an Underlying Manager, however, has not generally been a selection criterion for a FOF Manager.

*Funds that Invest in Non-Traditional Pools.* As a result of the inclusion of swaps in the definition of "commodity pool" and the Division's issuance of various letters over the past several months, many more investment vehicles may now be considered to be commodity pools.<sup>14</sup> Of those letters, only one addresses the status of the operator of a fund that invests in such a vehicle.<sup>15</sup> The other letters only address either the status of the Non-Traditional Pool itself as a commodity pool or whether the operator of the Non-Traditional Pool is required to register as a CPO. Those letters<sup>16</sup> generally do not impose *de minimis* limitations that are comparable to those in Regulations 4.5 and 4.13(a)(3); therefore, if commodity interest trading by these Non-Traditional Pools is attributed up to the FOF, it is not clear how the FOF Manager should account for this trading at the FOF level.

Funds that invest in Non-Traditional Pools do so as part of their overall investment strategy. These investments, with the exception of BDCs, traditionally have been considered

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<sup>13</sup> Even when an offering document provides this information, it usually notes that the Underlying Funds may be changed without notice to investors.

<sup>14</sup> See, e.g., CFTC No-Action Letter No. 12-44 (addressing mortgage REITs), CFTC No-Action and Interpretive Letters Nos. 12-14, 12-45 and 12-67 (addressing securitization vehicles), and CFTC No-Action Letter No. 12-40 (addressing BDCs). Only CFTC No-Action Letter No. 12-67 addresses the status of the operator of a fund that invests in a securitization vehicle and only CFTC No-Action Letters No. 12-40 and 12-44 require notice filings.

<sup>15</sup> See CFTC No-Action Letter No. 12-67.

<sup>16</sup> The sole exception is CFTC No-Action Letter No. 12-40.

securities and not investment pools.<sup>17</sup> Investors in these “inadvertent funds of funds” do not view these underlying securities as interests in commodity pools, nor are they investing in these funds to gain exposure to commodity interests through such securities. Instead, any such commodity interest exposure is merely a result of how the Underlying Manager of that Non-Traditional Pool manages the risks inherent in the Non-Traditional Pool (such as interest rate or foreign currency risk). To the extent that the fund is actively managed, the manager of the fund will buy and sell Non-Traditional Pools in accordance with its overall investment strategy for the fund.

3. Difficulty of Obtaining Information Regarding Commodity Interest Trading by Underlying Managers.

It is very difficult and extremely time consuming to get information from Underlying Managers regarding the extent of their Underlying Funds’ commodity interest trading if the Underlying Managers themselves are not relying on Regulation 4.5 or Regulation 4.13(a)(3) with respect to those Underlying Funds. Many ICI and IAA members diligently tried to gather this information in determining whether they could avail themselves of the deferred compliance date in Letter 12-38. As Underlying Managers usually consider their trading strategies to be proprietary, many either refused to respond to requests for information or provided only certain limited information on a lagged basis.<sup>18</sup> Because Underlying Managers responded to these questionnaires in disparate ways, using different limitations, ranges, and time periods, it was very difficult to get a precise view of the commodity interest trading by the FOF on a look through basis.

If an Underlying Manager is registered as a CPO or commodity trading advisor (“CTA”) and acting in a registered capacity with respect to the Underlying Fund, that manager would generally refuse to abide by any specific commodity interest trading limitations with respect to that Underlying Fund. Complying with a trading limitation may also be inconsistent with the Underlying Manager’s obligation to operate the Underlying Fund consistent with the Underlying Manager’s fiduciary duties to the Underlying Fund. Strict confidentiality obligations are commonplace in the private FOF space, and even Underlying Managers of Sub-Advised Sleeves have refused to provide real-time position level information to the FOF Manager because of confidentiality and selective disclosure concerns. Moreover, with respect to publicly offered or traded Underlying Funds or Underlying Funds purchased in secondary market transactions (such as certain registered funds, BDCs, REITs and securitization vehicles), the FOF Manager often

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<sup>17</sup> We request the same regulatory treatment for BDCs, however, because FOFs that invest in BDCs face the same informational obstacles with respect to investing in BDCs as they do with respect to investing in other Non-Traditional Pools. *See, infra*, note 27.

<sup>18</sup> Some Underlying Managers provided high and low end ranges either for one or both of the *de minimis* tests. Some provided information only with respect to certain recent periods (for example, as of the end of the first three quarters of 2012). Many would not commit to stay within these ranges for a period longer than the end of 2013.

does not have a relationship or direct contact with the Underlying Manager, making it even more difficult to get this information.<sup>19</sup>

To the extent a FOF Manager has any information about commodity interest trading by Underlying Managers, the information is usually obtained on a lagged basis, often through quarterly, semi-annual and annual financial reporting.<sup>20</sup> Some Underlying Managers may be unwilling to share trade data without use of a filter provided by a data aggregator, or even at all.<sup>21</sup> In any case, any data provided may not be of sufficient detail to compute compliance with *de minimis* limitations.

If some Underlying Managers are acting in a registered capacity with respect to certain Underlying Funds that do not adhere to the *de minimis* limitations in Regulation 4.5 or 4.13(a)(3), it is generally impossible for a FOF Manager to comply with those same limitations by attributing the commodity interest trading by the Underlying Funds up to the FOF and testing compliance at the FOF level. This difficulty is compounded by the requirement in Regulations 4.5 and 4.13(a)(3) that compliance with the *de minimis* limitations be measured each time a commodity interest position is established.<sup>22</sup> Moreover, even if a FOF Manager can convince an Underlying Manager to agree to abide by a limitation, it is very difficult for the FOF Manager to replace that Underlying Manager without having to readjust commodity interest limitations with all of the FOF's other Underlying Managers.

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<sup>19</sup> Consider, for example, a Global ex US Real Estate Income Fund whose investment objective is to track the performance of an index of 460 securities of non-US real estate companies and REITs. The investing fund typically owns all 500 securities of the index. A substantial percentage of such securities are foreign equity REITs. In order to ascertain whether an exemption or exclusion is available, the investing fund's operator would have to contact hundreds of REIT issuers, each of which individually comprises a very small percentage of the investing fund's overall assets. This exercise would be onerous and unlikely to generate the necessary information.

<sup>20</sup> Operators of private funds are generally required to furnish investors with audited financial statements as a result of the custody rule, Rule 206(4)-2 under the Investment Advisers Act of 1940 ("Advisers Act"). Even if the custody rule does not apply, market practice is for operators of private funds to provide annual audited financial statements. Registered funds must provide semi-annual unaudited and annual audited financial statements under the Investment Company Act. See Rule 30e-1 and Form N-CSR under the Investment Company Act. Registered funds also must file quarterly portfolio holdings information with the SEC. See Rule 30b1-5 and Form N-Q under the Investment Company Act.

<sup>21</sup> This information is frequently provided by Underlying Managers of private Underlying Funds to the FOF Manager through a data aggregator such as GlobeOp or Risk Metrics. Broad information sharing of Underlying Fund position level data is not market practice in the FOF industry.

<sup>22</sup> Even in situations where a FOF Manager invests in Underlying Funds advised by affiliated Underlying Managers, differences in technological systems and information barriers imposed to address selective disclosure and other regulatory issues may make it difficult for the FOF Manager to engage in real time monitoring of commodity interest positions at the Underlying Fund level.

## **Recommendations**

For the Guidance to be practical and useful to FOF Managers, it should reflect the difficulties FOF Managers have in obtaining information from Underlying Managers and address how investment in Non-Traditional Pools should be treated. We are concerned that, if the Division's Guidance requires that a FOF Manager effectively look through all of the Underlying Funds and Non-Traditional Pools in which a FOF invests to determine whether the FOF meets the *de minimis* limitations in Regulation 4.5 or 4.13(a)(3), a FOF Manager will be unable to obtain all of the necessary information and may therefore forgo investments that are otherwise consistent with or required by its FOF's investment strategy. This may artificially constrain how some FOF Managers construct their FOFs, to the detriment of FOF investors. As a matter of policy, the Division should not inadvertently encourage a FOF Manager to select one Underlying Fund over another simply because the Underlying Manager of the first fund determines to comply with the *de minimis* trading limitations, provides certain information or agrees to abide by an investment restriction on commodity interest trading. FOF Managers should not be left with a dilemma – either (1) change how their FOFs invest to comport with the Guidance, which may adversely affect FOF investors' returns and the FOF Manager's flexibility to change Underlying Funds at will, or (2) spend time and resources to register as a CPO out of an abundance of caution. We believe that our recommendations address this potential dilemma and achieve the goals identified above while not inappropriately excluding FOF Managers from registration and regulation by the CFTC.<sup>23</sup>

We recommend that the Guidance:

1. be crafted broadly to cover a range of FOFs;
2. permit a specified level of investment, without a look-through, in (a) Underlying Funds managed by registered CPOs and CTAs<sup>24</sup> that are acting in a registered capacity with respect to these Underlying Funds and (b) Non-Traditional Pools;
3. clarify the treatment of direct trading by the FOF Manager;
4. clarify the treatment of a Sub-Advised Sleeve, both as a portion of a "true" FOF and in a so-called "multi-manager" fund;
5. include a "reasonable belief" standard for FOF Managers that must look through certain Underlying Funds;

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<sup>23</sup> We recognize that the CFTC reserved consideration of a broad fund of funds exemption for a future date and we urge the CFTC to proceed with such consideration. See *Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations*, 77 Fed. Reg. 11252 at 11264 (February 24, 2012); correction notice published at 77 Fed. Reg. 17328 (March 26, 2012). In the meantime, however, we believe the Division should enable FOFs to flexibly apply existing exemptions.

<sup>24</sup> For purposes of this recommendation, registration as a CTA would only be sufficient if the CTA is managing a Sub-Advised Sleeve for the FOF Manager.



6. permit periodic testing for compliance with the *de minimis* limitations by the FOF Manager;
7. provide a transition period for a FOF Manager that can currently rely on Regulation 4.5 or 4.13(a)(3) and then subsequently determines that it needs to register as a CPO;
8. provide relief for FOFs that invest in Underlying Funds that do not issue interests/shares that are periodically redeemable (“Non-Redeemable Funds”); and
9. provide relief for FOFs that cannot easily change their investments once formed.

Nothing in our recommendations is intended to preclude a FOF Manager, if it can obtain the necessary information, from aggregating its direct commodity interest trading with indirect commodity interest trading at the Underlying Fund level and testing compliance with the *de minimis* limitations on an aggregated basis at the FOF level. This is consistent with Situation 4 of Former Appendix A. In addition, nothing in our recommendations should preclude a FOF Manager from imposing limitations on commodity interest trading by the Underlying Managers and at the FOF level and calculating compliance on a weighted average, which would be consistent with Situation 3 of Former Appendix A.<sup>25</sup>

1. Cover a Broad Range of FOFs.

In light of Dodd-Frank’s inclusion of swaps in the definition of “commodity pool” and the Division’s recent letters regarding Non-Traditional Pools, many more funds may be considered commodity pools simply because they invest in investment vehicles that trade swaps or because they invest in REITs, BDCs, or securitization vehicles that trade commodity interests. Thus, the universe of managers that may be considered to be CPOs of FOFs has greatly expanded. Because of the breadth of structures and forms FOFs may take, we continue to believe that the Guidance should be crafted broadly to cover a range of FOFs, whether registered under the Investment Company Act or excluded from such registration, including:

- a. a “true” FOF – a fund that invests in one or more registered funds and/or private funds, which also may have one or more Sub-Advised Sleeves;
- b. a “multi-manager” fund – a fund that consists solely of multiple Sub-Advised Sleeves;
- c. a fund that invests in Non-Traditional Pools; and

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<sup>25</sup> We do not believe the Guidance should generally apply to traditional master-feeder structures, where almost all of the investment activity takes place at the master fund level. Of course, if a master fund itself invests in Non-Traditional Pools, the Guidance should apply to the operator of the master fund and its feeder funds because, consistent with CFTC practice, the investment in Non-Traditional Pools will be attributed up to the feeder funds.

- d. a fund using any combination of the activities described in (a) and/or (c), with or without some direct trading in commodity interests by the FOF Manager.
2. Permit a Specified Level of Investment, Without a Look-Through, in Underlying Funds Managed by Registered CPOs and CTAs and in Non-Traditional Pools.
    - a. Underlying Funds Managed by Registered CPOs and CTAs.

We believe that the Guidance should permit a FOF to invest, without a look-through, in Underlying Funds managed by registered CPOs and CTAs that are acting in a registered capacity with respect to such Underlying Funds, subject to the limitations described in Subsection 2(c) below.<sup>26</sup> In this circumstance, little additional investor protection is provided by requiring a FOF Manager to register if the Underlying Managers are themselves registered and acting in a registered capacity with respect to those Underlying Funds. This is particularly true where the FOF Manager does not engage in direct trading of commodity interests or where the direct trading itself falls within the *de minimis* limitations in Regulation 4.5 or 4.13(a)(3).

As noted above, FOF investors invest in most “true” FOFs because they want the FOF Manager to select Underlying Funds, monitor them and replace them as necessary. FOF investors understand that the FOF Manager does not manage or direct the trading decisions made by the Underlying Funds. As described above, a FOF Manager typically has limited transparency to Underlying Funds’ trading activities and it is very costly for a FOF Manager to try to seek this information (with no guarantee of obtaining information that will be useful or comparable). In addition, it is unlikely that a registered CPO or CTA would agree to abide by a limitation on its commodity interest trading. The CFTC, on the other hand, will have complete transparency with respect to Underlying Managers that are registered so there will be no regulatory gap with respect to commodity interest trading by those managers.

- b. Non-Traditional Pools.

Securities issued by REITs, securitization vehicles, and BDCs are frequently purchased in the public markets or in secondary market transactions, in each case where there is usually no contact between the FOF Manager and the Underlying Manager. In these circumstances, a FOF Manager will not have a relationship with the manager of the Non-Traditional Pool that would allow the FOF Manager to request and obtain commodity interest trading information. Because of the extreme difficulty in obtaining commodity interest trading information in these circumstances, we believe that the Guidance should permit a FOF Manager to invest a certain amount, specified in Subsection 2(c) below, without a look-through, in Non-Traditional Pools that are commodity pools.

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<sup>26</sup> As stated above, for purposes of this recommendation, registration as a CTA would only be sufficient if the CTA is managing a Sub-Advised Sleeve for the FOF Manager.

As noted above, disclosure documents for these Non-Traditional Pools do not disclose the specific extent of commodity interest trading in a manner that would permit a FOF Manager to determine, at the time of investment, whether a Non-Traditional Pool satisfies the *de minimis* limitations.<sup>27</sup> If these disclosures are not required by regulation applicable to the Non-Traditional Pool, a FOF Manager is unlikely to have the market clout to obtain an Underlying Manager's agreement to make disclosures or to abide by trading limitations voluntarily. And the Underlying Manager has no obligation to update the offering documents for a Non-Traditional Pool that is not making a continuous offering.

Any reporting by Non-Traditional Pools is primarily supplied through financial reports with a significant lag between the end of the reporting period and the time the financial reports are furnished to investors. This financial information is not sufficiently detailed to understand (i) whether the instruments held at the end of a reporting period by a Non-Traditional Pool are commodity interests for purposes of the CPO definition,<sup>28</sup> (ii) the level of initial margin and premiums on those instruments, and (iii) the notional value of such instruments.

Although the Division's most recent letters on REITs, securitization vehicles, and BDCs have concluded that these vehicles may be commodity pools in certain circumstances, a FOF Manager may not be able to readily determine, by reviewing publicly available information, whether or not a particular Non-Traditional Pool is a commodity pool.<sup>29</sup> Moreover, the new Division relief for REITs and securitization vehicles is focused on vehicles that happen to comply or are structured to comply with certain provisions of U.S. law. FOF Managers may have purchased, and may wish to continue to purchase, other REITs and securitization vehicles. U.S. regulation should not inadvertently encourage a FOF Manager to select a particular product based on a regulatory difference, when investment in another product might provide the FOF's investors with a superior investment return.

As a result of the above, it is very difficult for a FOF Manager to know the extent of commodity interest trading by a Non-Traditional Pool such that the FOF Manager would be able to comply with the guidance in Former Appendix A. Thus, if more flexible compliance methods are not provided in the Guidance, the CFTC could cause a FOF Manager to register as a CPO even if the aggregate direct and indirect use of commodity interests by the FOF is limited. The FOF Manager may register because it has no way to demonstrate, using the methodologies

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<sup>27</sup> Operators of BDCs, when they claim the relief under CFTC No-Action Letter No. 12-40, are effectively representing that they comply with either the 5% initial margin and premiums limitation or the 100% aggregate net notional value limitation. We understand that these notices will be available on BASIC on the website of the National Futures Association ("NFA"). However, operators of BDCs are not required to annually reaffirm their eligibility as is required under CFTC Regulation 4.5.

<sup>28</sup> When reviewing the financial statements of a Non-Traditional Pool (or any other entity for that matter), it is particularly hard to distinguish swaps from security-based swaps, and whether a currency swap is a non-deliverable forward.

<sup>29</sup> See generally notes 14-16, *supra*, and accompanying text.

permitted by Former Appendix A or the Guidance, that it is complying with the *de minimis* limitations on a look-through basis.

c. Amount of Permitted Investment.

Because of the lack of transparency discussed above, we suggest that the allowable investment in Underlying Funds managed by registered CPOs and CTAs acting in a registered capacity and Non-Traditional Pools (collectively, “Specified Underlying Funds”) should be based on the amount of money invested by the FOF in these Specified Underlying Funds, rather than on the level of commodity interest trading by the Specified Underlying Funds. Accordingly, we respectfully request that a FOF Manager be deemed in compliance with Regulation 4.5 or 4.13(a)(3) provided that no more than 50% of the FOF’s gross assets are invested in Specified Underlying Funds, measured each time the FOF invests in a new Specified Underlying Fund.<sup>30</sup>

We believe that this approach is generally consistent with Situation 5 of Former Appendix A. The CFTC explained its adoption of Situation 5 in the Regulation 4.13(a)(3) Adopting Release, indicating that an investor fund in this situation has exposure to the futures markets that “may be said to be comparable to that of a stand-alone pool that meets the aggregate net notional value test” in Regulation 4.13(a)(3).<sup>31</sup> We also believe that only a limitation based on the amount of the FOF’s assets invested in Specified Underlying Funds is practical and that there should be no requirement that the FOF Manager seek to determine the level of commodity interest trading by each Specified Underlying Fund.

While, with this approach, it is possible that a FOF’s indirect exposure to commodity interests through Specified Underlying Funds could, in the aggregate, exceed the *de minimis* limitations in Regulation 4.5 and Regulation 4.13(a)(3) at certain times and under certain market conditions, this result would not raise significant policy concerns. First, if any Underlying Manager is not complying with the *de minimis* limitations or another exemption or no-action relief, it is presumably operating its Specified Underlying Fund as a registered CPO or CTA, subject to the rules and regulations of the CFTC and the NFA. Second, under both Regulation 4.5 and Regulation 4.13(a)(3), a FOF Manager would still be prohibited from marketing its FOF as a commodity pool or otherwise as a vehicle for trading in the commodity interest markets. Third, as discussed above, we do not believe that requiring a FOF Manager to register in order to provide FOF investors with more information about the Specified Underlying Funds will be materially beneficial to FOF investors because most FOF investors do not find this level of information to be useful in their decision-making process.<sup>32</sup> Finally, without flexible Guidance,

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<sup>30</sup> If the FOF Manager engages in some direct trading of commodity interests, this direct trading should be analyzed outside of the 50% gross assets test. See Recommendation 3.

<sup>31</sup> See Regulation 4.13(a)(3) Adopting Release, *supra* note 4, at 47225.

<sup>32</sup> Even if the FOF Manager registers as a CPO, many investors would not receive material additional information about the Underlying Funds. For example, most operators of privately offered FOFs would be able to rely on

the costs of pursuing and aggregating information about Specified Underlying Funds in the specific circumstances described above could be substantial. And, we believe, the costs associated with obtaining and regularly updating this information outweigh the marginal benefit of capturing a potentially limited number of FOF Managers whose investments in Specified Underlying Funds *may* in the aggregate cross the applicable thresholds.

3. Clarify the Treatment of Direct Trading.

A FOF Manager should be permitted to treat direct trading in commodity interests as an “Underlying Fund” for purposes of computing compliance with one of the *de minimis* limitations. Accordingly, the FOF Manager should be able to rely on either the 5% initial margin and premiums limitation or the 100% aggregate net notional value limitation for direct trading at the FOF level. This is consistent with Situation 6 of Former Appendix A.<sup>33</sup>

As noted above, a FOF Manager should also have the option to aggregate direct commodity interest trading with indirect commodity interest trading by Underlying Funds for purposes of computing compliance with either of the *de minimis* limitations, which would be consistent with Situation 4 of Former Appendix A.

4. Clarify the Treatment of a Sub-Advised Sleeve Both as a Portion of a “True” FOF and in a “Multi-Manager” Fund.

A FOF Manager should be permitted to treat a Sub-Advised Sleeve as an “Underlying Fund” for purposes of computing compliance with one of the *de minimis* limitations. Consequently, if the Underlying Manager of a Sub-Advised Sleeve complies with either the 5% initial margin and premiums limitation or the 100% aggregate net notional value limitation, the FOF Manager should be able to rely on that compliance for purposes of its own compliance. This is identical to Situation 2 of Former Appendix A if a Sub-Advised Sleeve were treated as an investee fund.

If the FOF is a “multi-manager” fund (a FOF composed solely of Sub-Advised Sleeves), this approach would permit the FOF Manager to rely on Regulation 4.5 or 4.13(a)(3) if some

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Regulation 4.7(b), and therefore would not be required to make disclosures to FOF investors who are qualified eligible purchasers about the Underlying Funds in which a FOF invests.

<sup>33</sup> See Regulation 4.13(a)(3) Adopting Release, *supra* note 4, at 47225 (identifying, as a guiding principle for the Commission’s adoption of Appendix A, that the relief afforded by Regulation 4.13(a)(3) should be available where an investor fund engages in direct commodity interest trading in addition to its allocation of assets to investee funds, provided the investor fund CPO treats the assets committed to direct trading as a separate pool with its own liquidation value and applies the trading restrictions to that “separate pool”).

Underlying Managers comply with the 5% initial margin and premiums limitation and others comply with the 100% aggregate net notional value limitation.<sup>34</sup>

5. Include a Reasonable Belief Standard with a Due Diligence Requirement.

Because a FOF Manager is relying on compliance by others, “reasonable belief” should be the compliance standard in the Guidance for investment in Other Underlying Funds,<sup>35</sup> assuming the FOF Manager makes reasonable efforts to obtain information about the Underlying Managers of these Other Underlying Funds. This is similar to the standard in Letter 12-38.

Specifically, the Division should permit a FOF Manager to rely on Regulation 4.5 or 4.13(a)(3) with respect to its FOF’s investment in Other Underlying Funds if (i) the FOF Manager reasonably believes that this portion of the FOF (the portion comprised of the FOF’s investment in all of the Other Underlying Funds in the aggregate) falls within one of the *de minimis* limitations in Regulation 4.5 or 4.13(a)(3) based on the information, if any, actually available to the FOF Manager; (ii) the FOF Manager reasonably believes that each Other Underlying Fund relies on either the 5% initial margin and premiums limitation or the 100% aggregate net notional value limitation;<sup>36</sup> or (iii) a combination of (i) and (ii). The FOF Manager would need to make reasonable efforts to obtain information sufficient to establish its reasonable belief. We do not believe that the Division should prescribe particular ways of performing this due diligence (as availability of information may change over time) or penalize a FOF Manager because it can only obtain information on a lagged basis or cannot obtain precise information. Reliance on exemption or exclusion notices posted on the NFA website should, of course, be *per se* sufficient.

6. Permit Periodic Testing.

Given the substantial difficulty of obtaining commodity interest trading information from Underlying Managers and the time lag in obtaining any such information, we recommend that the Guidance permit a FOF Manager to test its compliance with the *de minimis* limitations with respect to investments in Other Underlying Funds – that is, Underlying Funds that the FOF Manager must “look through” in some way – initially when the FOF makes its initial investments in Other Underlying Funds and then annually. We believe annual testing is appropriate because Regulation 4.5 and 4.13(a)(3) notices are reaffirmed annually and audited financial statements are provided annually. We recommend that FOF Managers confirm

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<sup>34</sup> Again, at its option, a FOF Manager should also be able to aggregate direct commodity interest trading with indirect commodity interest trading by Underlying Funds that are organized as investment vehicles and/or as Sub-Advised Sleeves for purposes of compliance with either of the *de minimis* limitations, which would be consistent with Situation 4 of Former Appendix A.

<sup>35</sup> The term “Other Underlying Funds” refers to both (a) direct investments by the FOF and (b) Underlying Funds other than Specified Underlying Funds (as defined on page 12 of this letter). These are funds the FOF Manager must “look through” in some way.

<sup>36</sup> See Situation 2 of Former Appendix A.

compliance with the *de minimis* limitations by May 31 of a year<sup>37</sup> based on information available as of the end of the prior year.

7. Provide a Transition Period.

If a FOF Manager claims the exclusion in Regulation 4.5 or the exemption in Regulation 4.13(a)(3) and then subsequently determines (through the reaffirmation process or otherwise) that it can no longer rely on the exclusion or the exemption, it should have a period of time to register and come into compliance with the CFTC's Part 4 rules. As noted above, it is difficult to get Underlying Managers to agree to abide by trading limitations, particularly in the context of Underlying Funds that do not adhere to the *de minimis* thresholds and publicly offered Underlying Funds. Moreover, FOF Managers are generally reliant on publicly available information to determine whether an Underlying Manager is relying on Regulation 4.5 or 4.13(a)(3), and there is a lag in the availability of that information to the FOF Manager. Underlying Managers have 60 days to reaffirm exemptions/exclusions after December 31; thus, in certain cases, the FOF Manager may not know if it has lost its exclusion/exemption until March of the following year.

If one Underlying Manager is terminated and a new Underlying Manager is hired, that can also affect *de minimis* limitation compliance at the FOF level. For policy reasons, FOF Managers should not be subject to an increased regulatory burden because they determine that they should redeem from an Underlying Fund or replace an Underlying Manager.

We recommend that a FOF Manager in this circumstance should, consistent with the time frame in Letter 12-38, have six months to register (or, if already registered, to operate the FOF in compliance with the CFTC's Part 4 rules), measured from the time the FOF Manager first learned that it is no longer in compliance with the Guidance. We also believe it would be appropriate for such a FOF Manager to be required to promptly file a notice with the Division indicating when the six month period has begun.

8. Provide Relief for FOFs that Invest in Non-Redeemable Funds.

A FOF Manager that invests in a Non-Redeemable Fund (such as a private equity, venture, real estate, credit, or similar fund) should not have to register as a CPO if the FOF complies with the *de minimis* limitations based on the information available at the time the FOF makes an investment in that Underlying Fund. In other words, subsequent changes in commodity interest trading by the Underlying Manager of a Non-Redeemable Fund should not cause the FOF Manager to have to register as a CPO if the FOF essentially is "locked into" that fund because it cannot redeem.

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<sup>37</sup> We recommend May 31 as most private fund financial statements are distributed within 120 days of year end (pursuant to Rule 206(4)-2 under the Advisers Act) and because it is after the 60 day period for reaffirmation of the notices required by Regulations 4.5 and 4.13(a)(3).

9. Provide Relief for FOFs that Cannot Change Their Investments Once Formed.

UITs are structured so that, once the UIT invests in particular Underlying Funds or other investments, those investments must remain the same for the stated term of the UIT unless the UIT obtains an order from the SEC under Section 26(c) of the Investment Company Act. Consequently, unless the UIT is permitted under Section 26(c) to substitute investments, the sponsor of a UIT that is a FOF should be able to test compliance with the *de minimis* limitations based on the information available at the time the UIT makes its investments; subsequent changes in commodity interest trading by the Underlying Funds once purchased should not affect whether or not the UIT sponsor must register as a CPO.<sup>38</sup>

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The ICI and the IAA appreciate the Division's consideration of this request. If you have questions or require further information, please contact Karrie McMillan at 202/326-5815, Sarah Bessin at 202/326-5835 or Rachel Graham at 202/326-5819 of the ICI, Karen Barr or Monique Botkin at 202/293-4222 of the IAA, or Cary Meer at 202/778-9107 or Lawrence Patent at 202/778-9219 of K&L Gates LLP.

In addition, several of our FOF members would be happy to meet with members of the Division either in person or via conference call so that they can further explain the difficulties of obtaining information about Underlying Funds and the need for flexible and workable Guidance. We are hopeful that we can schedule a meeting or call with you in the immediate future.

Sincerely,

/s/ Karrie McMillan  
Karrie McMillan  
General Counsel, Investment Company  
Institute

/s/ Karen L. Barr  
Karen L. Barr  
General Counsel, Investment Adviser  
Association

cc: Amanda Olear, Special Counsel  
Michael Ehrstein, Attorney-Advisor  
Division of Swap Dealer and Intermediary Oversight

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<sup>38</sup> If a UIT substitutes an investment, it should just be required to test compliance by substituting the new investment for the old investment.