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August 8, 2013

Via Electronic Mail: gbarnett@cftc.gov

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

Re: Application of the *de Minimis* Trading Tests in Regulation 4.5 and Regulation 4.13 to Funds of Funds

Dear Mr. Barnett:

The Asset Management Group (the "**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") is submitting this letter as a follow-up to the recent meetings we have had at the Commodity Futures Trading Commission (the "**CFTC**") regarding applicability of the amendments to Regulation 4.5 and Regulation 4.13 (the "**CPO Amendments**")[2] to operators of funds of funds.

We appreciate the staff's recognition of the importance of this issue to asset managers and the industry's need for appropriate, practical guidance in this area. We also appreciate the staff's issuance of no-action relief for operators of funds of funds, which in effect delays their obligation to register as CPOs until six months from the date that the staff issues revised guidance on the application of the calculation of the *de minimis* thresholds in the context of both Regulations 4.5 and 4.13(a)(3) to funds of funds operators, subject to certain conditions.[3] We have been pleased to learn that the staff intends to provide formal guidance that is both (1) principles based and (2) consistent with "commercially reasonable" standards for monitoring

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1 The AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.

2 Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 17 CFR Parts 4, 145, and 147 (February 9, 2012) (*available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912b.pdf).

3 CFTC No-Action Letter No. 12-38 (November 29, 2012) (the "fund of funds no-action letter").

compliance (the "Guidance"). To that end, we would like to recommend for your consideration as components of the Guidance certain principles, including compliance monitoring standards, that we believe will achieve the CFTC's regulatory goals in adopting the CPO Amendments, and, importantly, will do so without imposing undue costs and burdens on funds, their managers, and fund shareholders.

We also understand that the staff may include examples of how the principles set forth in the Guidance will operate in practice. To the extent these examples may reflect one or more of the situations and applications addressed in Appendix A (discussed below), we are also recommending clarification of certain matters.

Our recommendations, including a statement of the principles, are set forth below, accompanied by specific explanations where appropriate (some of them we view as self-explanatory). We have also provided a brief introduction designed to demonstrate how we believe the principles below align with the CFTC's goals in adopting the CPO Amendments, taking into account practical considerations and the CFTC's historical approach in this area.

Introduction to the Principles

The CFTC's Regulatory Goals – Achieving the Appropriate Regulatory Balance

The CFTC adopted the CPO Amendments with a view to "strik[ing] the appropriate balance between limiting the burden placed on registrants and enabling the Commission to carry out its duties under the [Commodity Exchange Act]."[4] On the one hand, the CFTC believed that certain funds relying on the previous exclusion were "offering interests in de facto commodity pools." By expanding the registration requirement, the CFTC sought "to eliminate informational 'blind spots,'" and to subject "similarly situated entities in the derivatives markets" – unregistered entities offering services substantially identical to those of registered CPOs – to the same regulatory regime.

On the other hand, the CFTC recognized its authority, and inherent obligation, to exempt persons from registration where it believes that "there is no substantial public interest to be served by the registration." The exclusion/exemption for CPOs of funds engaging in only a *de minimis* amount of derivatives trading reflects a recognition that no substantial public interest is served by CPO registration and regulation in such cases.

The Principles as Tools to Achieve the CFTC's Goals

In the Preamble to the CPO Amendments, the CFTC stated that a fund that invests in a commodity pool (a "fund of funds") is itself a commodity pool, and therefore the operator of such a fund (the "investor fund") must either register as a commodity pool operator or claim an

[4] Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 17 CFR Parts 4, 145, and 147 (February 9, 2012) (*available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912b.pdf).

exemption or exclusion (for simplicity, an "exemption"). In most cases, claiming an exemption would require the investor fund to meet one of the *de minimis* trading tests included in the CPO Amendments. The Preamble did not, however, explain how an underlying commodity pool (an "investee fund") should be taken into account in determining whether the investor fund can meet the tests.

Significantly, the answer to this question is not self-evident. The goal is to determine whether the investor fund "indirectly trade[s] commodity interests" in excess of the *de minimis* amounts "through participation in one or more funds that directly trades commodity interests."[5] However, given the multiplicity of fund investments that may now be considered commodity pools, the different reasons investor funds may invest in these vehicles, and severe limitations, in most cases, on the investor fund's access to specific information about the commodity pool's holdings, there is no single obvious or "common sense" method for determining how an investor fund should, or even can, take each commodity pool investment into account in applying the *de minimis* trading tests at the investor fund level. A pure "look-through" approach is neither logistically feasible – the investor fund will often not have the information – nor conceptually sound – in many cases the investor fund cannot reasonably be understood to be "indirectly" trading in the underlying fund's holdings.

The CFTC has long recognized the absence of a single solution to these difficulties. Former Appendix A to Part 4 of the CFTC's regulations ("Appendix A"), which was published in connection with the adoption of Regulation 4.13(a)(3) in 2003, took a blended approach.[6] Appendix A addressed six specific fund-of-funds fact patterns or "situations." Depending on the situation, the answers ("applications") use methodologies that reflect pass-through analysis, estimates, practice-based assumptions, and policy considerations, either alone or in combination. However, for a number of reasons, including the limitations of the six situations addressed, lack of clarity in the applications, and dramatic regulatory and market developments affecting funds of funds since 2003, it is widely acknowledged that Appendix A does not currently provide adequate guidance for determining whether funds of funds should be viewed as indirectly trading commodity interests within the *de minimis* limits.[7]

A vast number of fund investments are now, for the first time, considered commodity pools, or at least are commodity pools until proven otherwise. Because of the expansion of the term commodity interest to include swaps, and the CFTC's position that a pooled vehicle holding

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5 Advance Notice of Proposed Rulemaking, Commodity Pool Operators and Commodity Trading Advisors; Exemption From Requirement To Register for CPOs of Certain Pools and CTAs Advising Such Pools, 17 CFR Part 4 (November 2, 2002) (*available at* http://www.cftc.gov/files/opa/press02/opa17cfrpart4.pdf).

6 Although Appendix A was rescinded in connection with the CPO amendments, the staff has advised that CPOs of funds of funds may continue to rely on Appendix A until the CFTC adopts revised guidance. Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions – CPO/CTA: Amendments to Compliance Obligations (August 14, 2012) at 6-7 (*available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/faq_cpocta.pdf).

7 In recognition of the limitations of the Appendix A scenarios, and the difficulties in applying even that limited guidance, the staff has granted the fund of funds no-action letter.

even a single commodity interest is *prima facie* a commodity pool, collective investment vehicles such as real estate investment trusts ("REITs"), securitization vehicles and similar non-fund vehicles (collectively, "NFVs") that use swaps for hedging and other incidental purposes require a sophisticated analysis to determine whether or not they are commodity pools. This analysis requires review of the vehicle's structure, holdings, and purpose for using swaps, as well as review and application of the many CFTC staff interpretive and no-action letters addressing these vehicles. If the vehicle is not one of those addressed by the existing letters, the analysis may require discussion and resolution of the issue with the CFTC staff.

We understand the CFTC's desire to ensure that operators of these pools are, where appropriate, regulated as registered CPOs. But requiring an investor fund to conduct this analysis for, in some cases, hundreds of investments is both unrealistic and unnecessary. As the CFTC staff has acknowledged that broad categories of these vehicles either are not commodity pools or merit CPO exemptions, requiring vehicle-by-vehicle analysis by investor funds with the various conditions in letters issued by the staff is unlikely to serve any sound regulatory purpose. For these reasons, we propose in Principle No. 1 below that these NFVs should be excluded from the investor fund's *de minimis* testing.

The principles, therefore, are designed to provide fund of funds operators with the tools necessary to enable them to rely on the *de minimis* exemptions in situations where their trading in commodity interests is properly viewed as *de minimis* under the tests, without imposing unnecessary, and often impossible, compliance burdens.

The Principles

Principle No. 1. An investor fund that invests in NFVs need not consider commodity interest positions of the NFVs in calculating the investor fund's compliance with the trading tests. For this purpose, entities sponsored or advised by the investor fund's operator or investment adviser would not be considered NFVs.

Explanation. The goal in applying the *de minimis* test to funds of funds is to determine whether the investor fund "indirectly trade[s] commodity interests through participation in one or more funds that directly trades commodity interests" in excess of the *de minimis* limits. We do not believe that a fund's investment in NFVs can, in any meaningful sense, be viewed as trading in the underlying commodity interest positions of the NFV. On the contrary, fund investments in NFVs are designed to obtain access to the asset class represented by the NFV – for example real estate, in the case of REITs, and different classes of receivables, in the case of securitization vehicles – not as an indirect means of trading in commodity interests.[8] Therefore, we do not believe that there would be a substantial public interest served in trying to "look through" to these positions in considering whether the investor fund meets the *de minimis* trading tests.

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[8] *See, e.g.*, CFTC Interpretative and No-Action Letter No. 12-45 (December 7, 2012) (investment in the securitization was viewed as "essentially in the financial assets in the vehicle and not in the swaps"). *See also* CFTC Interpretative Letter No. 12-14 (October 11, 2012) (the requester asserted that securitization vehicles are "capital markets financings of sales finance or other financial asset inventory" as opposed to an investment trust).

Moreover, there is no practical mechanism either for determining whether the NFV is viewed by the CFTC as a commodity pool or for obtaining information about the NFV's holdings necessary for such a look-through approach. As a result, the burden of identifying the commodity interest positions of NFVs would far outweigh any potential benefit.

In many cases, because of existing staff interpretations and positions with respect to NFVs discussed above, we would, in theory, reach the result reflected in Principle No. 1 without further staff guidance in the fund-of-funds context. For example, the staff has recognized that domestic equity REITs are generally not commodity pools, even though they hold swaps or other commodity interests, because these REITs "primarily derive their income from the ownership and management of real estate" and "use derivatives for the limited purpose of 'mitigat[ing] their exposure to changes in interest rates or fluctuations in currency'. . ."[9] The staff has taken a similar position with respect to certain securitization vehicles ("excluded securitization vehicles").[10] Because these REITs and excluded securitization vehicles are not commodity pools, investor funds holding them would not, by virtue of those holdings, be commodity pools, or in any way be required to look through to the REITs' or excluded securitization vehicles' commodity interest positions in determining the investor fund's compliance with the *de minimis* trading tests.

Similarly, for other types of NFVs, such as mortgage REITs meeting certain conditions, the staff has provided no-action relief from the CPO registration provisions for the NFV's operator.[11] The staff has also recognized that the operator of a fund that invests in this type of NFV would be entitled to comparable relief.[12]

A practical problem, however, which creates a necessity for Principle No. 1, is that funds are simply not in a position to determine, for each NFV, whether the NFV meets all the conditions of the staff's interpretations. Many funds have hundreds of NFV holdings, which they trade frequently. In all likelihood, all or most REITs that are organized in the United States and market themselves as equity REITs will meet the criteria of the staff's interpretation and can be disregarded in the calculation. Securitizations in certain classes may also, for the most part, be presumed to be excluded securitization vehicles. But many vehicles that are functionally similar, and should be treated by the investor fund in the same manner, are not within the four corners of existing guidance.

Foreign REITs are a good example. Real estate funds often invest in foreign REITs as well as, or instead of, domestic REITs, depending on the geographic focus of the funds. Just as with domestic REITs, global real estate funds buy foreign REITs as a diversified and liquid alternative to direct ownership of real property. And while foreign REITs are typically

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9 CFTC Interpretative Letter No. 12-13 (October 11, 2012).

10 *See, e.g.*, CFTC Interpretative Letter No. 12-14; CFTC Interpretative and No-Action Letter No. 12-45.

11 CFTC No-Action Letter No. 12-44 (December 7, 2012).

12 CFTC No-Action Letter No. 12-67 (December 21, 2012).

structured and function in a similar manner as domestic REITs, and hold themselves out as such, they are not included in the staff's REIT interpretation, because, among other conditions, the staff's letter imposes U.S. tax requirements. Foreign REITs will, of course, be subject to the tax and other laws of their countries of domicile, not U.S. law. It would be ironic, to say the least, to be forced to conclude that investments in these foreign entities are subject to CFTC jurisdiction when investments in their U.S. counterparts are not. As we have articulated in previous meetings, treating investor funds holding foreign REITS differently than those holding domestic REITS will place additional administrative burden and expense on these investor funds, with no policy benefit, and thus lead to a clearly unwarranted result.

For these reasons, absent Principle No. 1, operators of investor funds would have to conduct painstaking and, we believe, ultimately futile inquiries for each NFV, despite the absence of any tangible regulatory benefit or the intention of the CFTC to regulate these funds.

From the perspective of the investor fund, not the pool itself or its operator, and given that the staff's letters to date generally acknowledge the non-pool or exempt status of these vehicles, it should be the rule, not the exception, that the NFV should not be counted for purposes of applying the *de minimis* thresholds to an investor fund, and thus we believe that a categorical, rather than vehicle-by-vehicle, approach strikes the right regulatory balance.

Principle No. 2. An investor fund that allocates less than 10% of its assets (in the aggregate) to investee funds that use commodity interests should not be considered a "fund of funds" that is required to look through to or otherwise consider the investee funds' commodity interests in the investor fund's determination of whether it meets the trading tests. The 10% threshold would be determined at the time of the initial investment in and additional allocation of assets to an investee fund.

Explanation. In applying the *de minimis* test to investor funds, it makes sense to establish a threshold of investee fund holdings below which it is highly unlikely that that the test would be exceeded, and thus the burdens involved in applying a look through do not serve a substantial public interest. We suggest setting the threshold at 10%. This is consistent with the approach taken by the Securities and Exchange Commission ("SEC") in its Form ADV. See Question 8 of Section 7.B.(1)A of Schedule D, which defines a fund of funds as a fund that invests 10 percent or more of its total assets in other pooled investment vehicles or registered investment companies.

Principle No. 3. In testing for compliance, the investor fund may rely on the most recent information that the investee fund has provided to the public or, in the case of private investee funds, to its investors, on or before the date as of which the investor fund calculates compliance with the test (the "calculation date"). Principle No. 3 would not apply to testing for affiliated funds (funds that are operated or advised by the operator or adviser of the investor fund) where the investor fund has access to the necessary information by means of reasonable efforts ("affiliated funds"). [13]

[13] The investor fund may also rely on information appearing on the NFA's "BASIC" website or direct representations from investee funds or their advisers.

Principle No. 4. Investor funds should not be required to test investee fund positions (other than for affiliated funds) more than once a year. An appropriate calculation date would be the date (usually March 1) on which Regulation 4.5 and Regulation 4.13(a)(3) require investee funds (or their CPOs) relying on those exemptions to file with the NFA a notice reaffirming such reliance (the standard reaffirmation date). Investor funds (and their CPOs) may file their annual reaffirmation notice (or withdraw the notice, if appropriate) within 60 days after the standard reaffirmation date.

Explanation. In many cases, investor funds will be relying on the annual affirmation of investee funds or financial information provided after the end of the calendar year. Accordingly, as a practical matter, investor funds will need a reasonable period of time (60 days) after obtaining this information to determine their own compliance with the *de minimis* tests and file their own reaffirmation notices with the NFA.

Recommendations Relating to Examples

We understand that the Guidance may include examples of how the principles set forth in the Guidance will operate in practice, and that the fact patterns addressed in the examples may include situations similar to those set forth in Appendix A. The following recommendations provide clarification regarding the use of examples in the Guidance and specific questions that have arisen with respect to interpretation of Appendix A.

Clarification No. 1 – Combination of Fact Patterns and Principles. To the extent that the Guidance provides examples of fact patterns and application of the principles to the fact patterns, an investor fund should be able to combine fact patterns presented in the examples and adapt them based on the principles. For example, an investor fund holding (i) direct commodity positions, (ii) investee funds relying on Regulation 4.5 or Regulation 4.13(a)(3), and (iii) investee funds with registered CPOs should be able to assess its direct and indirect trading in commodity interests using different methods appropriate to each category, in accordance with the principles, to determine its overall compliance with the *de minimis* tests.

Clarification No. 2 – Situation 4. To the extent that the Guidance provides an example incorporating the pure "look-through" approach described in Situation 4 of Appendix A (where the investor fund has actual knowledge of the investee fund's commodity interests), an investor fund that holds investee funds and also invests in commodity interests directly should be able to consolidate direct commodity interest holdings with investee fund commodity interest holdings and test ratably in the aggregate based on the percentage of the investor fund invested in each investee fund or directly in commodity interests. The investor fund need not test its direct holdings as a separate pool.[14]

[14] Note that, in accordance with Principle No. 2, the investor fund need only count the commodity interest positions of investee funds if more than 10% of the investor fund's assets are allocated to investee funds that use commodity interests.

Clarification No. 3 – Situation 6. To the extent that the Guidance provides an example reflecting a fact pattern similar to Situation 6 of Appendix A (where the investor fund holds both investee funds and direct holdings of commodity interest positions), and chooses to treat assets committed to direct holdings as part of a separate pool, the investor fund would treat all of its assets other than investee funds that use commodity interests as assets of the separate pool. Accordingly, assets held in underlying funds that do not hold commodity interests (which by definition are not commodity pools) would be assets of the separate pool and included in the denominator when testing the direct holdings in this separate pool. As a result, the investor fund would test its direct commodity interest holdings against all assets, including assets invested in these underlying funds, other than assets invested in the investee funds that use commodity interests. Underlying funds that do not hold commodity interests may include, for example, most money market funds and cash sweep vehicles.

Explanation. This is consistent with current Situation 6, which distinguishes between investee funds and other assets. The term investee fund in Appendix A is used to refer to funds that invest in commodity interests. Accordingly, underlying funds that do not invest in commodity interests would be part of the separate pool. In addition, based on Clarifications 1 and 2, above, the separate pool treatment should be optional, and the investor fund should also, in appropriate circumstances, be able to rely on the Situation 4-type analysis, and aggregate holdings across the fund.

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The AMG appreciates the CFTC's consideration of these comments and stands ready to provide any additional information or assistance concerning these topics that the CFTC might find useful. Should you have any questions, please do not hesitate to call Tim Cameron at 212-313-1389 or Matt Nevins at 212-313-1176.

Sincerely,

Timothy W. Cameron, Esq.
Managing Director, Asset Management Group
Securities Industry and Financial Markets Association

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Matthew J. Nevins, Esq.
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cc: Amanda Olear, Associate Director, Division of Swap Dealer and Intermediary Oversight
Hon. Gary Gensler, Chairman
Hon. Bart Chilton, Commissioner
Hon. Scott O'Malia, Commissioner
Hon. Mark Wetjen, Commissioner