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The Future of Managed Futures Funds

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In 2003, the Commodity Futures Trading Commission (CFTC) amended Rule 4.5 under the Commodity Exchange Act (CEA) to enlarge the exclusion from the definition of the term "commodity pool operator" (CPO) for "otherwise regulated persons" operating certain "qualified entities."[1] The amended rule made it possible for investment companies registered under the Investment Company Act of 1940 (the 1940 Act) to expand their use of commodity futures and options without regulation as CPOs. Over the intervening years, dozens of registered investment companies that invest in commodity futures and options for non-hedging purposes have filed notices for exclusion under Rule 4.5. The CFTC is now proposing amendments to Rule 4.5 that would reverse the 2003 amendments and impose restrictions on the use of commodity options and futures by registered investment companies. These amendments, if adopted, could adversely affect registered investment companies and their shareholders.

Registered Investment Companies and Rule 4.5

Investment funds that engage in futures and options trading generally are considered to be CPOs under the CEA, which broadly defines a CPO to include, in part:

> any person engaged in a business that is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property … for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract

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market or derivatives transaction execution facility.[2]

Persons meeting the definition of a CPO are required to register with the CFTC, unless an exclusion from registration is available.[3] Rule 4.5 under the CEA excludes from the definition of a CPO certain "otherwise regulated persons," including investment companies registered under the 1940 Act.[4]

Prior to 2003, a registered investment company claiming an exclusion under Rule 4.5 was required to file a notice of eligibility pursuant to Rule 4.5(c) and represent, in part, that it would:

(i) Use commodity futures or commodity options contracts solely for bona fide hedging purposes;[5]

(ii) Limit the use of commodity futures or commodity option contracts for non-hedging purposes to not more than five percent of the liquidation value of its investment portfolio (Five Percent Test);[6]

(iii) Not market shares of the fund to the public as a commodity pool or as a vehicle for trading in the commodity futures or commodity options markets (Marketing Limitation);

(iv) Disclose in writing to each prospective participant the purpose of the commodity futures and commodity options trading in which it engages and any limitations on the scope of such trading; and

(v) Submit to any special calls the CFTC may make in order to determine that the registered investment company is in compliance with the provisions of Rule 4.5(c).[7]

In August 2003, the CFTC amended Rule 4.5 to provide an expanded exclusion from the definition of a CPO.[8] The 2003 amendments eliminated the limitations on futures and commodity trading activities by otherwise regulated persons, including registered investment companies, allowing such entities to invest in commodities options and futures for both hedging and non-hedging purposes. The amendments also eliminated the Five Percent Test and the Marketing Limitation. However, a new condition was added to Rule 4.5 requiring registered investment companies to disclose in writing to each shareholder that the fund is operated by a person that is claiming an exclusion from the term "commodity pool operator" and, therefore, not subject to regulation and registration under the CEA.[9] The CFTC adopted the amendments based upon its belief that registered investment companies were "otherwise regulated" under the 1940 Act, thus providing adequate customer protection in the absence of the Five Percent Test and the Marketing Limitation.[10]

Advent of Managed Futures Funds

The 2003 amendments to Rule 4.5 made it possible for registered investment companies to expand their use of commodity futures and options without regulation as CPOs. Since 2003, a number of registered investment companies that pursue managed futures trading strategies for non-hedging purposes have filed notices for exclusion under Rule 4.5.[11] These registered investment companies generally invest in commodity- and currency-linked derivative instruments, such as commodity options and futures contracts, options on futures, forward commodity and currency contracts, swaps, and other instruments that provide exposure to the investment returns of the commodities markets without investing directly in physical commodities. As required by Rule 4.5, these investment companies disclose in their prospectuses or statements of additional information that they have filed with the NFA a notice claiming an exclusion from the definition of the term "commodity pool operator" under the CEA and the rules of the CFTC and, accordingly, are not subject to registration or regulation as a CPO.

These funds typically gain exposure to the commodity markets by investing up to 25 percent of their total assets in wholly-owned subsidiaries organized in the Cayman Islands, which in turn invest, directly or through pooled investment vehicles, in futures, options, forward contracts and other derivative instruments linked to or deriving their value from commodities, currencies, interest rates, stock market indices, energy resources, metals or agricultural products. Because the subsidiaries are wholly-owned and controlled by the registered investment companies, they generally also are managed by the investment company's adviser or an affiliate of the adviser. The subsidiaries are not registered under the 1940 Act, are not subject to all the investor protections of the 1940 Act, and can invest without limitation in commodity-linked instruments.[12] Nevertheless, a registered investment company employing the subsidiary structure typically discloses in its prospectus that the subsidiary is managed pursuant to compliance policies and procedures that are identical in all material respects with the policies and procedures of the controlling investment company. As a result, the subsidiary is subject to the same policies and restrictions relating to portfolio leverage, liquidity, brokerage and valuation of portfolio investments as is the registered investment company. Because it is wholly-owned by the registered investment company, the subsidiary's financial statements are either included in the registered investment company's shareholder reports or consolidated with the financial statements of the registered investment company.

Indirect investments in commodities through a subsidiary are necessary because Subchapter M of the Internal Revenue Code of 1986, as amended, requires a registered investment company to realize at least 90 percent of its annual gross income from "qualifying income," that is, dividends, interest and other investment-related sources.[13] Direct investment by a registered investment company in commodity-related instruments generally does not produce qualifying income.[14] Consequently, registered investment companies seek private letter rulings from the Internal Revenue Services (IRS) that provide that income from a wholly-owned subsidiary that invests in futures, options, forward contracts and other derivative instruments linked to or deriving their value from commodities, currencies, interest rates, stock market indices, energy resources, metals or agricultural products constitutes qualifying income. Each private letter ruling is conditioned on representations from the registered investment company that the subsidiary will comply with Section 18(f) of the 1940 Act and related guidance from the Securities and Exchange Commission (SEC) pertaining to asset coverage and the use of leverage by registered investment companies.

The NFA Rulemaking Petition

On August 10, 2010, the NFA filed a rulemaking petition (Petition) requesting that the CFTC amend Rule 4.5 to impose on registered investment companies operating restrictions that are substantially similar to the restrictions in effect prior to the 2003 amendments.[15] In the Petition, the NFA contended that while registered investment companies employing managed futures strategies are doing so in compliance with Rule 4.5, as amended in 2003, these funds do not afford investors the adequate customer protections envisioned by the CTFC when it amended Rule 4.5 in 2003. In particular, the NFA stated that registered investment companies employing managed futures strategies are marketed as commodity futures investments, are sold to unsophisticated retail customers who seek exposure to actively managed futures strategies and, as part of their principal investment strategy, invest in unregulated subsidiaries that invest in other actively managed futures trading programs.[16] Citing the unregulated nature of the subsidiaries and a perceived lack of transparency in the investment portfolios of the subsidiaries, the NFA asserted that the premises underlying the CTFC's removal of the Five Percent Test and the Marketing Limitation—that the entities investing in the commodities were "otherwise regulated"—is no longer valid.[17] The NFA argued that a registered investment company that is marketed, in part, to unsophisticated retail customers as a commodity pool or otherwise as a vehicle for trading in, or otherwise seeking exposure to, the commodity futures or options markets, or that engages in more than a de minimus amount of non-hedge futures trading, should be subject to the regulatory requirements, protections, and oversight of the CFTC and NFA, each of which has the experience and expertise to regulate retail managed futures products.[18] To that end, the NFA proposed that Rule 4.5 be amended to add the following:

> (iii) Furthermore, if the person claiming the exclusion is an investment

company registered as such under the Investment Company Act of 1940, then the notice of eligibility must also contain representations that such person will operate the qualifying entity as described in [Rule] 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 [Rule] 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 [Rule] 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 [Rule] 190.01(x) may be excluded in computing such [five] 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.

The NFA acknowledged that if the proposed amendments are adopted, registered investment companies that have filed notices of exclusion pursuant to Rule 4.5 may no longer be eligible for the exclusion and may need to register as CPOs or seek other appropriate relief.[19] On September 17, 2010, the CFTC solicited public comment on the NFA Petition.

Notice of Proposed Rulemaking

On February 11, 2011, the CFTC issued a Notice of Proposed Rulemaking (Notice) proposing to amend Rule 4.5 as requested in the NFA Petition. Citing the recent economic turmoil and the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the Notice states that the CFTC

> [h]as reconsidered the level of regulation that it believes is appropriate with respect to entities participating in the commodity futures and derivatives markets. The Commission believes that it is necessary to rescind or modify several of its exemptions and exclusions to more effectively oversee its market participants and manage the risks that such participants pose to the markets.[20]

The Notice observes that the proposed amendments are designed to bring the CPO and CTA regulatory structure into alignment with the Dodd-Frank Act; encourage more "congruent and consistent regulation of similarly situated entities among Federal regulatory agencies"; and increase transparency of the activities of CPOs and CTAs, and the commodity pools that they operate or advise.[21]

Ramifications for Managed Future Mutual Funds

Adoption of the proposed amendments could have far-reaching ramifications for registered investment companies.

Additional Layer of Regulation. Under the proposed amendments to Rule 4.5, any registered investment company that invests more than a de minimus amount of assets in commodity futures and options for non-hedging purposes would be required to register as a CPO. As a result of registration, the registered investment company would be required to comply with the regulation in 17 CFR Part 4 regarding required disclosures,[22] delivery of disclosure documents,[23] reporting to participants,[24] recordkeeping,[25] and advertising.[26] These regulations are in addition to the comprehensive requirements of the 1940 Act. Registered investment companies would need to devote additional resources to complying with these regulations and, in some cases, would find it difficult to reconcile adherence to the rules with the manner in which fund shares are sold.[27] In addition, it is possible that the officers and directors of the registered investment company and its investment adviser would be required to register as CPOs.

Elimination of the Subsidiary Structure. The proposed amendments actually go beyond reinstating the pre-2003 operating limitations. As proposed, amended Rule 4.5 would not only reinstate the Five Percent Test, but also would expand the restriction on trading in commodity futures and options for non-hedging purposes by limiting the exclusion in Rule 4.5 only to the qualifying entity holding the commodity option or futures positions. Because many registered investment companies hold positions in commodity futures and options contracts indirectly through Cayman Island-domiciled subsidiaries, these positions may not be considered to be "held by the qualifying entity," thus forcing the registered investment company to either register as a CPO or discontinue investing in the subsidiary. The NFA Petition suggests that such a result is appropriate because the subsidiary is unregulated and thus poses a risk of harm to investors. However, as mentioned earlier, the requirement in the private letter rulings issued by the IRS that a subsidiary comply with Section 18(f) of the 1940 Act and related SEC guidance imposes significant restrictions on the investment activities of the subsidiaries and adds substantial investor protections. Eliminating the use of subsidiaries could severely limit an investor's ability to diversify his or her portfolio through access to the commodity markets. At the same time, it is unclear whether the restrictions will result in an appreciable increase in investor protection.

Expansion of the No-Marketing Limitation. The proposed amendments also would reinstate the Marketing Limitation, and broaden its application so that Rule 4.5 would be unavailable to any registered investment company that markets its shares as participations in a vehicle "otherwise seeking investment exposure to"the commodity futures or commodity options markets. In its comments on the NFA Petition, the Investment Company Institute (ICI) suggests that the new language may be interpreted to apply to registered investment companies whose investment portfolios, whether directly or through a fund-of-funds structure, have only a modest exposure to commodity futures and options.[28] The ICI also notes that the proposed Marketing Limitation is broad enough that it could apply to an investment company's use of commodity futures or options for *bona fide* hedging purposes, as well as to non-hedging commodity trading activity that complies with the Five Percent Test.

Swap Transactions. Finally, as the ICI points out in its comment letter, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act expands the definition of a CPO to include any person engaged in trading swaps and other derivatives.[29] As a result, swap transactions would be included in the types of instruments covered under an amended Rule 4.5. Many registered investment companies, including fixed-income funds, use interest rate and total return swaps as part of their principal investment strategies. Adopting the proposed restrictions could affect, when applied to swap transactions, a broad range of registered investment companies.

Conclusion

Dozens of registered investment companies with billions of dollars of assets now offer retail investors exposure to the commodity markets. These funds provide additional asset class diversification to the stock and fixed income portfolios of retail investors, and inject liquidity into the commodity markets. Adoption of the amendments to Rule 4.5 as proposed could have a significant and disruptive effect on registered investment companies.

Notes

1. 68 Fed. Reg. 47221 (Aug. 8, 2003).
2. 7 USC §1(a)(5).
3. Persons required to register under the CEA also must become members of the National Futures Association (NFA), a self-regulatory organization designated by the CFTC.
4. Rule 4.5(a) provides that certain regulated persons, and any principal or employee thereof, are excluded from the definition of the term "commodity pool operator" with respect to the operation of a qualifying entity listed in Rule 4.5(b). Investment companies registered under the 1940 Act qualify as both a regulated person as well as the qualifying entity itself. A registered investment company's adviser would be subject to regulation under the CEA as a commodity trading adviser (CTA), unless an exemption applies.
5. The term "bona fide hedging" is defined in Rule 1.3(z)(1).

6. A qualifying entity may aggregate initial margin and premiums required to establish such positions, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into.

7. 17 CFR 4.5

8. *Id*. at 1.

9. Rule 4.5(c)(2)(i) permits this disclosure to be made in a fund's prospectus or statement of additional information.

10. *See* 68 Fed. Reg. 47221, 47223 (March 8, 2003).

11. *See, e.g*., Mutual Hedge Frontier Legends Fund (MHFAX); AQR Managed Futures Strategy Fund (AQMIX); Highbridge Dynamic Commodities Strategy Fund (HDSAX); ASG Managed Futures Strategy Fund (AMFAX); Rydex Managed Futures Strategy Fund (RYMFX); Wisdom Tree Managed Futures Strategy Fund; Altegris Managed Futures Strategy Fund (MFTAX); Invesco Commodities Strategy Fund (COAAX).

12. The subsidiaries also generally are not regulated by the CFTC and the NFA.

13. "Qualifying income" includes income derived from dividends, interest, proceeds from securities lending, gains from the sale or other disposition of stock, securities and foreign currencies, or other income (including, but not limited to, gains from options, futures, or forward contracts) derived with respect to a regulated investment company's business of investing in such stock, securities, or currencies. *See* 26 U.S.C. §851(b)(2).

14. Rev. Rul. 2996-1, 2006-2 I.R.B.1.

15. Petition of the National Futures Association, Pursuant to Rule 13.2, to the U.S. Commodity Futures Trading Commission to Amend Rule 4.5*,* 75 Fed. Reg. 56997 (Sept. 17, 2010)

16. The Petition states:

> 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.

17. *Id*. at 15.

18. In explaining the reason for Petition, the NFA states that:

> [I]t is interested in ensuring that registered investment companies that engage in more than a de minimus 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 minimus amount of futures trading or investment to be registered as [CPOs] furthers that goal.

19. *Id*. at 15.

20. 79 Fed. Reg. 7976, 7977 (Feb. 11, 2011).

21. 79 Fed. Reg. 7976, 7978 (Feb. 11, 2011).

22. 17 CFR 4.24.

23. 17 CFR 4.21

24. 17 CFR 4.22.

25. 17 CFR 4.23.

26. 17 CFR 4.25

27. In particular, 17 CFR 4.21 requires that a disclosure document be delivered to and acknowledged by each investor. Considering the variety of distribution channels in which mutual funds are sold, it is unlikely that most funds will be able to comply with this requirement.

28. Letter from the Investment Company Institute to David A. Stawick, Secretary, Commodity Futures Trading Commission (Oct. 18, 2010).

29. *Id*. at 28. *See also,* Section 721 of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.