No Action Request
Investment Company
Act of 1940
Sections 3(a)(1),
3(a)(3) and 3(b)(1)

MANAGED FUTURES ASSOCIATION

July 11, 1996

ACT ICA
SECTION 3(a)(3), 3(b)(1)
RULE
PUBLIC AVAILABILITY 7/15/96

Mr. Jack W. Murphy
Associate Director and Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: "No Action Letter" Request Relating to the Status Under the Investment Company Act of 1940 of Certain "Commodity Pool" Funds of Funds

Dear Mr. Murphy:

The Managed Futures Association (the "MFA")[1] is submitting this "No Action Letter" request under the Investment Company Act of 1940, as amended, and the regulations promulgated thereunder (the "Act"), to the Division of Investment Management (the "Division") of the Securities and Exchange Commission (the "SEC" or the "Commission"), to ask that the Division confirm by letter that it will not recommend enforcement action to the Commission if a class of commodity pools structured as "funds of funds" operate without registration under the Act as investment companies. The MFA is seeking general "No Action" relief in order to provide the managed futures industry with guidance concerning the ability of commodity pool operators ("CPOs") to structure "funds of funds" commodity pools while ensuring that these pools not be deemed to constitute investment companies required to be registered under the Act. This submission is based on (i) a belief that the Staff should "look through" commodity pools' "funds of funds" investments in "second-tier" commodity pools to the underlying economic activity of such "second-tier" pools and (ii) the "otherwise regulated" character of both commodity pool "funds of funds" and the "second-tier funds" in which they invest.

Limited Scope of Request

The MFA has purposefully formulated this request restricting the "No Action" relief being sought solely to commodity pools that are (A) sponsored and operated by CPOs registered under the Commodity Exchange Act, as amended, and the regulations promulgated thereunder (the "CEA") and (B) primarily engaged in trading "commodity interest contracts," (i) directly through managed accounts, (ii) through investing, directly or

[1] The MFA is the not-for-profit national trade association representing the managed futures industry. The MFA membership includes the sponsors, trading advisors and commodity brokers for substantially all of the commodity pools marketed on either a public or a private basis in the United States.

indirectly, in other commodity pools which meet the criteria in A and B (just as do the investing pools themselves) or (iii) a combination of (i) and (ii). The focus of this request is on the ability of "otherwise regulated" "funds of funds" to evaluate their primary purpose under the Act by "looking through" the commodity pools in which they invest to the underlying commodity interest contract trading in which such "second-tier funds" are themselves primarily engaged. The context of this request involves entities whose substantive economic activity is trading commodity interest contracts, not securities. This is not a context in which the MFA believes that there should be any meaningful regulatory incentive or justification for applying the literal terms of the Act, while the adverse effects of not granting the requested relief have been, are now, and are becoming increasingly, onerous to the managed futures industry.

The Need for Relief

The Act cannot regulate commodity pool "funds of funds"; it can only prohibit them. There are numerous provisions in the Act which are fundamentally inconsistent with the operation of the typical "commodity pool."[2] It is against the reality of prohibition, not regulation, that the need for relief must be evaluated. At the same time, it must be made clear that, while commodity pool "funds of funds" are fundamentally incompatible with the Act, this structure is, due to its utility and efficiency, in widespread and routine use as a means of structuring commodity pools in financial markets outside of the United States. The applicability of the Act in strict accordance with its terms, to the "funds of funds" structure has become a major impediment and competitive disadvantage to the United States managed futures industry -- despite the clear objective of these "funds of funds" primarily to trade instruments which are not regulated by the Commission.

The need for "funds of funds" relief under the Act is acute. Principal among the reasons for the urgency of this request is the fact that many of the more experienced and successful "commodity trading advisors" ("CTAs") can only be accessed by investing in a pooled entity (typically organized and operated by the CTAs themselves). There are many advantages for a CTA in managing a single pool rather than a plethora of individual managed accounts. In managing a single account, a CTA need not be concerned with inadvertently treating one account inequitably as compared to another; the CTA is able to enter and exit markets more efficiently and generally obtain better executions by entering one, rather than numerous orders; the CTA has only one account for which trade reconciliations need be made; the CTA has only one account requiring trade confirmations

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[2] For example, the Act's restrictions on paying incentive fees, leverage, and "senior securities" as well as investor liquidity, among others, conflict with the basic models used for United States commodity pools.

and monthly statements; and regulatory compliance and performance computations are dramatically simplified.[3] In addition, managed accounts are disfavored, as compared to pools, by CTAs seeking to preserve the confidentiality of trading systems, and who fear that unscrupulous clients in possession of trade data (managed account clients must, by law, be given daily confirmations of all trading activity in their accounts; an investor in a private fund receives a net asset value report instead -- the fund and the CTA being the only recipients of trade confirmations) might attempt to "reverse engineer" the CTAs' trading systems (with the intent of trading against or ahead of these systems) or disclose their open positions to other traders.

It is not only the CTAs which benefit from "pooling" clients' funds. Investors themselves benefit from the reduced administrative costs, enhanced accuracy and greater efficiency in order execution and allocation. A managed account also has the distinct disadvantage that it exposes investors to unlimited liability -- a particularly important drawback from the perspective of investor protection given the high degree of leverage available in futures trading and the very real chance of incurring a deficit balance. However, perhaps the greatest client benefit of pooling is that pooled vehicles permit clients to obtain professional management of their capital which would otherwise be unavailable to them. Many major CTAs currently have minimum account sizes of $5 million. This required minimum capital commitment precludes even certain of the larger multi-advisor pools from placing assets directly with such CTAs, while were such pools able to invest in a pooled entity, the minimum investment in such entity could be much smaller.

Despite the fact that commodity pool "second-tier funds" operate, both in substance and in intent, as conduits to their CTAs' commodity interest contract trading, under current law the nature of the economic activity of the investing "funds of funds" is transformed for regulatory purposes from what it really is -- commodity interest contract trading -- to what it really is not -- investing in securities -- merely as a result of the "fund of funds" structure. A pool which trades commodity interest contracts directly is clearly not an investment company. However, if the same commodity pool accesses a CTA through a "second-tier" commodity pool, operated by a registered CPO, the investment in the "second-tier" entity is no longer treated as commodity interest contract trading, but as an investment in

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[3] Under the CEA, it is necessary to have established the methodology by which "bulk orders" will be allocated among the individual client accounts participating in the bulk order before the trade is transmitted to the exchange floor for execution. It is not permitted, as it is in the case of securities accounts, to allocate positions at the end of the trading day so as to achieve an equitable or "average price" allocation of trade "fills." Consequently, different managed accounts traded pursuant to the same managed futures program frequently experience materially different cumulative performance over time, simply due to order allocations.

securities. Such an investment -- at least if in excess of 25% of the "fund of funds" commodity pool's assets (see Ft. Tryon Futures Fund Limited Partnership, available August 16, 1990) -- potentially causes the investing commodity pool -- despite the economic substance of its trading program -- to fall within the definition of an investment company, thereby effectively precluding the investment. The MFA believes there is no justification for this result. Provided that the "second-tier fund" primarily trades "commodity interest contracts" as proposed in this "No Action" request, there is no possibility for abuse.

The harm to the managed futures industry and to its clients from commodity pools not being able to access CTAs through "second-tier funds," operated by registered CPOs, as opposed to managed accounts, is material. Indeed, so material that in the absence of "No Action" relief, there can be no doubt, and must be grave concern, that the United States managed futures industry will be crippled by the continued loss of many of the industry's most successful money managers who are no longer willing to manage U.S. investor capital. The draconian consequences of being held in violation of the Act -- including rescission liability -- combined with the current uncertainty of the distinction between commodity pools and investment companies has an in terrorem effect which drives talented CPOs and CTAs to manage only offshore money, despite the underlying economic activity of the CPOs and CTAs clearly focusing on trading commodity interest contracts, rather than securities. No regulatory purpose can be served by compelling CPOs who wish to access the most successful CTAs to do so only on behalf of foreign investors, while U.S. persons effectively are precluded from investing in commodity pools sponsored by such CTAs because their doing so causes their portfolio objective to be recast -- purely for regulatory purposes, not in terms of economic substance -- into securities investing rather than commodity interest contract trading.

Safeguards Against Abuse as a Result of the Otherwise Regulated Status of Commodity Pool "Funds of Funds"

In order to ensure that the proposed exemption is only available to appropriate pools, the MFA proposes that each of the investor and investee pools must be managed by a CPO registered under the CEA. The CEA imposes disclosure, reporting and recordkeeping requirements, as well as providing for regular audits conducted by the National Futures Association, the self-regulatory body of the United States managed futures industry. In addition, the CEA provides investors with a panoply of administrative, arbitral and judicial remedies, in conjunction with an explicit "private right of action." Because these commodity pools are already comprehensively regulated by the CFTC, the agency presumptively expert in their operation, any abuses which might arise from this structure can be dealt with by the CFTC which has broad authority under the CEA to take appropriate action. Such relief will not result in carving out

an unregulated sector of the financial markets, but rather acknowledges that the commodity pool "funds of funds" in question are subject to the jurisdiction of their primary federal regulator.

Conclusion

In the case of commodity pool "funds of funds" in which all "second-tier funds" are primarily engaged in trading commodity interest contracts rather than securities, and in which the "funds of funds" themselves are (through investing in such "second-tier funds" or directly through managed accounts) primarily engaged in trading commodity interest contracts, the MFA respectfully requests the Staff to confirm that it would not recommend enforcement action to the Commission if such "funds of funds" operate without registration under the Act. To grant such relief would be to permit regulation on the basis of the substantive economic activity while at the same time removing a major impediment to the continued pre-eminence of the managed futures industry. This can be readily accomplished, without need of amending any of the terms or the policies of the Act, by adopting a "look through" analysis and permitting commodity pool "funds of funds" to be regulated not by the Act, but by the CEA -- the statute specifically enacted to govern the commodity interest contract markets as well as United States entities which trade in such markets.

The MFA, and the managed futures industry which it represents, much appreciate the Staff's attention to these matters. If you have any questions regarding the foregoing or desire any additional information, please contact the undersigned at (202) 872-9186.

Due to the importance of this issue to the industry, we do not request confidential treatment for this submission, unless the Staff feels that such treatment would be appropriate.

In accordance with Release No. IC-6330, we herewith submit this original letter plus six copies.

Respectfully submitted,

John G. Gaine

John G. Gaine
General Counsel
Director, Government Relations
Managed Futures Association

JUL 15 1996

Our Ref. No. 96-94
Managed Futures Association
File No. 132-3

RESPONSE OF THE OFFICE OF CHIEF COUNSEL,
DIVISION OF INVESTMENT MANAGEMENT

Your letter dated July 11, 1996, requests our assurance that we would not recommend that the Commission take any enforcement action if certain commodity pools operate in the manner described in your letter without registering as investment companies under the Investment Company Act of 1940 ("Investment Company Act").

The Managed Futures Association (the "MFA") is a national trade association representing the managed futures industry. The MFA's members include the sponsors, trading advisers and commodity brokers for the publicly and privately marketed commodity pools in the United States. The MFA is seeking no-action relief under the Investment Company Act to permit certain commodity pools to invest some or all of their assets in interests of other commodity pools ("second-tier pools"), without registering as investment companies under the Investment Company Act.

You represent that the requested relief is necessary to enable commodity pools to obtain the expertise of many of the more experienced and successful commodity trading advisors ("CTAs") who increasingly prefer to advise their clients to invest in a single managed trading account -- the second-tier pool -- rather than manage numerous separate client accounts. You represent that a single managed trading account presents a number of operational advantages for a CTA. In using such an account, for example, the CTA need not be concerned with inadvertently treating one account more favorably than another. The CTA is also able to enter and exit markets more easily and to obtain more favorable executions by placing a single order rather than multiple orders. In addition, the CTA has only one account for which trade reconciliations need to be made and for which trade confirmations and monthly statements are required to be delivered.[1] You further represent that managing a single pooled account may help successful CTAs keep their trading strategies confidential.

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[1] You represent that under the Commodity Exchange Act ("CEA"), a CTA must establish a methodology for allocating "bulk orders" among its individual client accounts before the bulk order or trade is made, and that consequently, different accounts managed by the same CTA may experience materially different cumulative performance over time simply due to order allocations. You represent that a single account eliminates inequities due to the order of trade allocations.

You assert that this pooling of client accounts benefits a CTA's clients as well. You note that when a commodity pool invests in futures contracts directly, the pool is exposed to unlimited liability for losses on those contracts. In contrast, by investing through a second-tier pool (typically a limited partnership), a pool can obtain limited liability and some degree of protection from the substantial risk created by the high degree of leverage available in the futures markets.

You state that this two-tiered commodity pool structure raises issues under the Investment Company Act. Specifically, because passive interests in second-tier pools likely would be deemed to be securities under the Investment Company Act,[2] a commodity pool investing through second-tier pools may fall within the definition of "investment company" under Sections 3(a)(1) and 3(a)(3).[3] You note, however, that registration under and compliance with the Investment Company Act are impractical for most commodity pools, because there are numerous provisions of the Investment Company Act that are fundamentally inconsistent with the operation of a typical commodity pool.[4]

You propose that, in the case of a commodity pool that (1) is sponsored and operated by a commodity pool operator ("CPO") registered as such under the CEA, and (2) invests some or all of

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[2] Section 2(a)(36) of the Investment Company Act defines "security" to include, among other things, any note, stock, treasury stock, bond, debenture, evidence of indebtedness, or certificate of interest or participation in any profit-sharing agreement.

[3] Section 3(a)(1) defines "investment company" to include any issuer which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." Section 3(a)(3) defines "investment company" to include any issuer which "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis." Securities issued by commodity pools are "investment securities" for purposes of Section 3(a)(3).

[4] You represent that the Investment Company Act's restrictions relating to, among other things, liquidity of portfolio investments, the use of leverage, and the issuance of senior securities would conflict with the operations of most U.S. commodity pools.

its assets in second-tier pools that (i) are not investment companies, and (ii) are sponsored and operated by CPOs registered as such under the CEA, the CPO of such a pool be permitted to "look through" its investments in the second-tier pools to the second-tier pools' investments for purposes of determining whether the pool meets the definition of an investment company. You note that a pool that primarily invests directly in commodity interests is not deemed to be an investment company. You maintain that when the same pool uses one or more second-tier pools as conduits to access the commodities trading expertise of particular CTAs, the nature of the pool's investments is unchanged -- it remains essentially an investment in commodity interests.

You represent that the operators of pools for which you seek relief are subject to comprehensive regulation by the Commodity Futures Trading Commission ("CFTC") pursuant to the CEA. As a result, you maintain that regulation of such pools under the Investment Company Act is both duplicative and unnecessary. You assert that such pools are held out to the public as commodity pools regulated by the CFTC and not as investment companies under the regulation of the Commission. Finally, you submit that for these reasons, there is no justification for subjecting the pool to different regulatory schemes depending upon whether it invests in commodity interests directly or through one or more second-tier pools.

Analysis

Many commodity pools that are held out to the public as such can meet the definition of investment company in Section 3(a)(3) in view of the nature of their business.[5] A commodity pool that meets the definition of investment company in Section 3(a)(3) nonetheless may be excluded by Section 3(b) of the Investment Company Act. Section 3(b)(1) excludes from the definition of investment company any issuer engaged primarily in a business or businesses other than investing, reinvesting, owning, holding or

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[5] We understand that the assets of commodity pools typically consist in large part of cash and government securities, which are used to margin futures contract obligations. Because cash and government securities are excluded from total assets for purposes of applying Section 3(a)(3), any other securities held by a commodity pool become a significant percentage of the pool's total assets, causing the pool to meet the definition of investment company contained in that section.

trading in securities, either directly or through wholly-owned subsidiaries.[6]

In Tonopah Mining Co. of Nevada ("Tonopah"),[7] the Commission adopted a five factor analysis for determining an issuer's primary business for purposes of assessing the issuer's status under the Investment Company Act. Although the Commission decided Tonopah under Section 3(b)(2) of the Investment Company Act[8], the same factors are relevant to determining an issuer's primary business under Section 3(b)(1).[9] These factors are: (1) the company's historical development; (2) its public representations of policy; (3) the activities of its officers and directors; (4) the nature of its present assets; and (5) the source of its present income. In Tonopah, the Commission accorded the fourth and fifth factors the most weight.

The staff has recognized that a commodity pool's balance sheet may not necessarily be a useful indicator of the pool's primary business for purposes of assessing the pool's status under the Investment Company Act. The staff has taken the

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[6] Section 3(b) does not exclude issuers meeting the definition of investment company in Section 3(a)(1). If an issuer is found to be "primarily engaged" in a business other than investing, reinvesting, owning, holding, or trading in securities for purposes of Section 3(b)(1), however, it necessarily will be engaged primarily in a business other than investing, reinvesting, or trading in securities for purposes of Section 3(a)(1). Therefore, unless an issuer holds itself out as being primarily engaged in the business of investing, reinvesting, or trading in securities, a determination that an issuer meets the standards for exclusion under Section 3(b) is, by definition, a determination that it is not an investment company under Section 3(a)(1). See ICOS Corporation; Order Granting Exemption, Investment Company Act Release No. 19334 (Mar. 16, 1993); M. A. Hanna Co., 10 S.E.C. 581 (1941).

[7] 26 S.E.C. 426 (1947).

[8] Section 3(b)(2) authorizes the Commission to issue orders excluding issuers engaged primarily in a business or businesses other than investing, reinvesting, owning, holding, or trading in securities directly, through majority-owned subsidiaries, and through certain controlled companies.

[9] See Investment Company Act Release No. 10937 (Nov. 13, 1979) (proposing Rule 3a-1), n.24.

position, therefore, that in determining the primary business of a commodity pool, the most important factor to be considered is the portion of the pool's business with respect to which it anticipates realization of the greatest gains and exposure to the largest risk of loss.[10] In our view, therefore, a commodity pool's primary business should be deemed to be investing or trading in commodity interests if (1) the pool looks primarily to commodity interests as its principal intended source of gains, (2) the pool anticipates that commodity interests present the primary risk of loss, and (3) the pool's historical development, public representations of policy (in its prospectus or offering circular and in marketing materials), and the activities of those charged with management of the pool demonstrate that the pool's primary business is investing or trading in commodity interests, rather than securities.

Without necessarily agreeing with your legal analysis, we would not recommend that the Commission take any enforcement action under the Investment Company Act if, when assessing for purposes of Section 3(b)(1) whether or not a commodity pool is primarily engaged in the business of trading or investing in commodity interests, the commodity pool "looks through" the second-tier pools in which it has invested and treats the business activities of each second-tier pool as having been engaged in directly by the commodity pool itself, provided that (1) the commodity pool is operated by a CPO registered as such under the CEA, and (2) each second-tier pool (i) is operated by a CPO registered as such under the CEA, and (ii) is not an investment company, and is not excluded from regulation under the Investment Company Act by Section 3(c)(1) thereof.[11]

Because the position set forth above is based on the facts and representations in your letter, you should be aware that different facts and representations may require a different result.[12] Moreover, this response expresses the Division's views

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[10] Peavey Commodity Futures Fund (pub. avail. June 2, 1983)("Peavey").

[11] The position taken in this letter should not be read to provide any relief from the Section 3(a)(1) definition of investment company to any commodity pool that holds itself out as being primarily engaged in the business of investing, reinvesting or trading in securities. Such a commodity pool would be an investment company under the Investment Company Act.

[12] We recognize that this position requires an analysis of the primary business activities of each second-tier pool under Peavey. In determining the nature of the

(continued...)

on enforcement action only and does not purport to express any legal conclusions on the questions presented.[13]

Phillip S. Gillespie
Senior Counsel

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[12](...continued)
business activities of a second-tier pool, however, a commodity pool may, in our view, rely on representations made in the prospectus or other offering documents of such second-tier pool and on the representations of the second-tier pool's CPO, unless the commodity pool's CPO knows or has reason to know that such representations do not accurately reflect the nature of the second-tier pool's business activities.

In performing an analysis of its primary business activities under Peavey, a second-tier pool that invests in other commodity pools may likewise "look through" to the business activities of the pools in which it has invested in accordance with the terms of this letter.

[13] This response in no way addresses the status of interests in second-tier pools as securities for purposes of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, or other provisions of the Investment Company Act.