MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

September 25, 2009

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Harmonization of Regulation; File Number 4-588

Dear Ms. Murphy and Mr. Stawick:

Managed Funds Association ("MFA") appreciates the opportunity to participate on the "Regulation of Investment Funds" panel at the joint meeting of the Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC") on harmonization of regulation on September 3, 2009. We are pleased to submit this letter to supplement our written statement from September 3rd to respond to the question Commissioner Aguilar asked me at the joint meeting. Specifically, Commissioner Aguilar asked me to submit a proposed framework for determining an adviser's primary business and regulator.

As previously stated, MFA supports adviser registration. MFA believes that an adviser should be subject to either the CFTC or SEC's registration framework depending on whether it is primarily engaged in the business of advising on the value or advisability of trading in futures or securities. Advisers who are equally or largely engaged in advising on both futures and securities should be subject to both CFTC and SEC registration. We support the current statutory framework, which provides an exemption for an adviser that is registered with one agency and is not primarily engaged in advising activity within the other agency's purview from registration with the other agency.[1] We believe that this framework promotes efficiency, reduces overlap, helps prioritize regulatory resources, and reduces compliance cost to advisers and their customers.

Current Framework

In particular, section 203(b)(6) of the Investment Advisers Act of 1940 ("Advisers Act") provides an exemption from registration for "[a]ny investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading advisor whose business does not consist primarily of acting as an investment adviser" and that does not act as an investment adviser to a registered investment company or a business development company.

[1] *See* Section 203(b)(6) of the Investment Advisers Act of 1940 and Section 4m(3) of the Commodity Exchange Act.

Similarly, Section 4m(3) of the Commodity Exchange Act ("CEA") provides an exemption from registration for "any commodity trading advisor that is registered with the Securities and Exchange Commission as an investment adviser whose business does not consist primarily of acting as a commodity trading advisor . . . and that does not act as a commodity trading advisor to any investment trust, syndicate of similar form of enterprise that is engaged primarily in trading in any commodity for future delivery . . . ."

To date, the Commissions have not provided explicit guidance in interpreting an adviser's primary engagement. We believe the standard set in the Peavey Commodity Futures Fund SEC No-action letter[2] (Peavey) to determine the primary business engagement of a fund for purposes of determining whether it is an investment company under section 3(b)(1) of the Investment Company Act of 1940 ("Company Act") is a fair and flexible standard for determining whether an adviser registered with the CFTC is primarily acting as an investment adviser pursuant to section 203(b)(6) of the Advisers Act. In addition, we believe the same analysis may be applied for purposes of determining whether an adviser registered with the SEC is primarily acting as a commodity trading advisor pursuant to section 4(m)(3) of the CEA.

Section 3(b)(1) of the Company Act excludes from the definition of investment company any issuer engaged primarily in a business or businesses other than investing, reinvesting, owning, holding or trading in securities, either directly or through wholly-owned subsidiaries.

Under the Peavey analysis, in determining whether an entity investing in futures was otherwise primarily engaged in the business of investing in securities so as to be an investment company, the SEC considered the composition of the entity's assets, the sources of its income, the area of business in which it anticipated realization of the greatest gains and exposure to the largest risks of loss, the activities of its officers and employees, its representations, its intentions as revealed by its operations, and its historical development. The SEC recognized that with respect to a commodity pool, "a snapshot picture of its balance sheet contrasting the value of its futures contracts (unrealized gain on such contracts) with the value of its other assets" may not reveal the primary nature of the business as a pool's reserves and margin deposits are generally in the form of United States government notes and other securities.[3] In Peavey, the SEC stated that of greatest importance in its analysis was the area of business in which the entity anticipated realization of the greatest gains and exposure to the largest risks of loss as revealed by its operations on an annual or other suitable basis.[4]

We believe the factors under the Peavey analysis are appropriate for determining the primary business activity of an adviser and whether it should be registered with the CFTC, SEC or both. Accordingly, we recommend the Commissions, in determining whether an adviser is acting primarily as an investment adviser or a commodity trading advisor, to consider the Peavey

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[2] *See* Peavey Commodity Futures Fund, SEC No-Action Letter (pub. avail. June 2, 1983), 1983 SEC No-Act. LEXIS 2576 ("Peavey") (determining the primary engagement of a fund for purposes of the Investment Company Act of 1940). *See also,* Tonopah Mining Co. of Nevada, 26 S.E.C. 426 (1947) (adopting a five factor analysis for determining an issuer's primary business for purposes of assessing the issuer's status under the Investment Company Act of 1940).

[3] *See id.*

[4] For example, a company's anticipated gains and losses in futures trading as compared to its anticipated gains and losses on its government securities and other securities.

analysis—the composition of the adviser's assets, the sources of its income, the area of business in which the adviser anticipates realization of the greatest gains and exposure to the largest risks of loss, the activities of its officers and employees, its representations, its intentions as revealed by its operations, and its historical development.

For your convenience, we have attached a copy of Peavey, as well as a copy of the Managed Futures Association SEC No-action letter, which applies a "look through" analysis in determining the primary business of a commodity pool that invests in other commodity pools.[5]

Oversight and Examination

The SEC has oversight and examination authority over investment advisers and the CFTC and National Futures Association ("NFA") have oversight and examination authority over commodity trading advisors and commodity pool operators. We support enhancing coordination, communication and consultation among the SEC, CFTC and NFA with respect to examinations of dual registrants. As discussed in our written statement, we believe the regulators should consider developing a shared internal database of advisers who engage in futures and securities activities to assist with regulation and oversight of registrants. We believe a shared database would facilitate and promote the sharing of information between the regulators and enhance coordination and regulation. Such a database would provide a regulator with information about an adviser that engages in securities and futures activities regardless of an adviser's registration status (*e.g.,* single or dual registrant).

* * * * *

We support a regulatory framework that requires an adviser to be subject to either the CFTC or SEC's registration framework depending on whether it is primarily engaged in the business of advising on futures or securities. To the extent that an adviser is equally or largely engaged in advising on both futures and securities, we believe the adviser should be registered with both the CFTC and SEC. We believe that such a framework, combined with enhanced SEC and CFTC coordination and communication, such as through a shared adviser database and with respect to examinations, would maximize regulatory efficiency and effectiveness while reducing compliance costs for advisers and their customers.

[5] Managed Futures Association, SEC No-Action Letter (pub. avail. July 15, 1996), 1996 SEC No-Act. LEXIS 623. Managed Futures Association subsequently changed its name to Managed Funds Association.

MFA appreciates the opportunity to share its views on the SEC and CFTC's harmonization of regulation and is committed to working with regulators to enhance our regulatory system. If the Commissioners or staffs have any questions or comments, please contact Jennifer Han or the undersigned at (202) 367-1140.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO

CC: The Hon. Mary Schapiro, Chairman, SEC
The Hon. Kathleen L. Casey, Commissioner, SEC
The Hon. Elisse B. Walter, Commissioner, SEC
The Hon. Luis A. Aguilar, Commissioner, SEC
The Hon. Troy A. Paredes, Commissioner, SEC

The Hon. Gary Gensler, Chairman, CFTC
The Hon. Michael Dunn, Commissioner, CFTC
The Hon. Jill E. Sommers, Commissioner, CFTC
The Hon. Bart Chilton, Commissioner, CFTC

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Research Information

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Print Request: Current Document: 1
Source: Get by LEXSEE(R)
Search Terms: 1983 SEC No-Act. LEXIS 2576

Send to: LEXIS.COM, 1332TZ
SMITH BUCKLIN & ASSOCIATES
1200 19TH ST NW STE 300
WASHINGTON, DC 20036-2412

1983 SEC No-Act. LEXIS 2576

Investment Advisors Act of 1940 -- Section 202(a)(11)

Jun 2, 1983

[*1] Peavey Commodity Futures Fund

TOTAL NUMBER OF LETTERS: 4

SEC-REPLY-1: SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
June 2, 1983
RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 83-15-CC
Peavey Commodity Futures Funds, I, II, III
File No. 132-3

On December 7, 1981, the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC") announced an agreement (the accord) as to the appropriate scope of their respective jurisdictions. (S.E.C. Release No. 81-66, Dec. 7, 1981.) Subsequently, in February 1982, the two agencies submitted to Congress proposed legislation which embodied the essence of the accord, accompanied by a joint explanatory statement. n1 The proposed amendments to the federal securities and commodities laws were finally codified in Public Law No. 97-303, 96a Stat. 1409 (1982), and the Futures Trading Act of 1982, Pub. L. No. 97-444, *96 Stat. 2295 (1983)* ("Futures Trading Act of 1982"), respectively.

n1 See, S.E.C. Release No. 82-9 (Feb. 2, 1982) and H.R. REP No. 626 Pt. II, 97th Cong., 2d Sess. 10-16 (1982).

Although neither the accord, the explanatory statement, nor the legislation enacted [*2] pursuant to the accord state that futures contracts on financial instruments and stock indices are not securities, they indicate that it was intended that the CFTC would have exclusive jurisdiction over futures contracts on exempted securities (other than municipal securities) and on broad-based groups or indices of any securities, and over options on any such futures contracts. n2 In addition, the Futures Trading Act of 1982 codifies the following three points as stipulated to in the accord n3: (1) no trading will be permitted in futures contracts (or options on futures contracts) on individual corporate and municipal securities; (2) the SEC may allow options on foreign currency to trade on national securities exchanges, while the CFTC will have jurisdiction to regulate the trading of options on foreign currency in the commodities markets; and (3) the CFTC will consult with the SEC on any application submitted by a board of trade for designation as a contract market with respect to any futures contract on a group or index of securities.

n2 H.R. REP. No. 565 Pt. I, 97th Cong., 2d Sess. 38 (1982), and *7 U.S.C. § 2*, as amended by Futures Trading Act of 1982, § 101(a)(3).

n3 Futures Trading Act of 1982 sections 101(a)(3)(B)(iv), (v) and 102.

[*3]

The CFTC's exclusive jurisdiction pursuant to section 2(a)(1) of the Commodity Exchange Act ("CEA") over accounts involving futures on commodities or options thereon was made subject by the Futures Trading Act of 1982 to, among other things, the provision that the Securities Act of 1983 and the Securities Exchange Act of 1934 would apply to the issuance of securities by commodity pools (see section 103 of the Futures Trading Act of 1982 adding new subsection (2) to section 4m of the Commodity Exchange Act). With respect to this change, the joint explanatory statement said:

While the CFTC has adopted extensive regulations governing the activities of commodity pool operators and has exclusive jurisdiction with respect to "accounts * * * involving" futures, the SEC has taken the position that the activities of a commodity pool as a company, i.e. its formation, capital raising, and continued corporate existence are subject to the federal securities laws. The draft legislative language would make this result explicit by stating that nothing in the CEA affects the applicability of the Securities Act and the Exchange Act with respect to securities issued by commodity pools and transactions [*4] therein. Of course, the proposed language would not affect the exclusive jurisdiction granted by the CEA with respect to state regulation. Moreover, in appropriate circumstances, commodity pools and persons managing them may be subject to the Investment Advisors Act of 1940 and if a pool conducts not only a commodities business but also acts as an investment company, the Investment Company Act of 1940 (emphasis added). n4

n4 H.R. REP. No. 626 Pt. II, 97th Cong., 2d Sess. 14 (182). Note that the Senate Report on S. 2260, the bill originally introduced pursuant to the accord to amend the securities laws (corresponding to H.R. 6156 enacted as Pub. L. No. 97-303), makes the same statement. S. REP. No. 390, 97th Cong., 2d Sess. 7 (1982).

The Senate Agricultural Committee said with respect to the same amendment:

The new amendment does not imply that the Investment Company Act of 1940 and the Investment Advisors [sic] Act of 1940 are applicable to the activities of commodity pools, commodity pool operators, and commodity trading advisors when such entities or persons purchase commodity futures contracts (or options thereon) based on securities or give advice as to the purchase [*5] and sale of futures contracts (or options thereof) based on securities. n5

n5 S. REP. No. 384, 97th Cong., 2d Sess. 82 (1982).

It appears, therefore, that without regard to whether futures on securities or options on such futures are securities, an entity investing in such interests is not subject to the jurisdiction of the SEC under the Investment Company Act of 1940 unless such entity is otherwise an investment company under the Investment Company Act, in which case the person advising the investment company about its investments in futures may be an "'investment adviser' of an investment company" under section 2(a)(20) of the Investment Company Act n7 and its contract subject to the provisions of section 15 of the Investment Company Act. A person giving advice concerning the making of investments in futures on exempted securities (other than municipal securities) or in futures on indices of securities as permitted pursuant to the Futures Trading Act of 1982, or as previously approved by the CFTC, or on options on such futures is excluded by the CEA from being subject to the jurisdiction of the SEC under the investment Advisers Act of 1940 unless the person provides [*6] advice about investing in securities, otherwise than by advising about such futures or options on such futures or about certain securities which may be termed, generally, United States government securities. n8

n7 Under this section, to be an investment adviser of an investment company, it is not necessary for a person to give advice about securities; advice with respect to the desirability of investing in any property would suffice.

n8 A person giving advice only with respect to securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury pursuant to section 3(a)(12) of the Securities Exchange Act of 1934 as exempted securities for the purposes of that Act, is excepted from the definition of "investment adviser" by clause E of section 202(a)(11) of the Investment Advisers Act.

In determining whether an entity which invests in futures, including futures in exempted securities and futures on indices of securities, and options on such futures, [*7] is otherwise an investment company, one must determine first whether the entity is otherwise within the definition of an investment company contained in section 3(a) of the Investment Company Act. Generally, this would require a determination of whether the entity was, otherwise than by its in-

vestment in such futures or options on such futures, either primarily engaged in investing in securities so as to be an investment company under section 3(a)(1) of the Investment Company Act, or on an entity with more than 40 percent of its total assets (exclusive of Government securities and cash items) in investment securities so as to be an investment company within section 3(a)(3) of the Investment Company Act.

If the entity was not an investment company within the meaning of section 3(a)(1), but was within 3(a)(3), the entity would, nevertheless, still not be an investment company if it was excepted by section 3(b)(1) as an entity which was primarily engaged, directly or through a wholly-owned subsidiary, in a business or businesses other than trading in securities. In applying this provision to an entity engaged in investing in the aforementioned futures or options on such aforementioned [*8] futures, we would, in accord with section 2(a)(1) of the CEA, consider the entity not to be subject to SEC jurisdiction under the Investment Company Act if it was directly or indirectly primarily engaged in the business of investing in futures including the aforementioned futures and options thereon.

In determining an entity's primary engagement one usually looks to the composition of its assets, the sources of its income, the activities of its officers and employees, its representations, and its historical development. The first two of these factors are usually regarded as the most telling. However, it has been recognized that with respect to a commodity pool, a snapshot picture of its balance sheet contrasting the value of its future contracts (unrealized gain on such contracts) with the value of its other assets, e.g., its reserves and margin deposits, which often are in the form of United States government notes, may not reveal the primary nature of the business. In other words, the fact that such an entity, otherwise than by reason of its investment in futures, has more than 50 percent of its assets in securities would not necessarily indicate that it is primarily engaged [*9] in investing in securities. See, Alpha-Delta Fund (pub. avail. May 4, 1976).

In determining whether an entity investing in futures was otherwise primarily engaged in the business of investing in securities, we would consider of first importance the area of business in which the entity anticipates realization of the greatest gains and exposure to the largest risks of loss. Thus, at least with respect to such a company, a company's intentions are of great importance in determining its primary business. However, a company's real intentions may be revealed by its operations and, therefore, its gains and losses in futures trading, in comparison to its gains and losses on its government securities and other securities would be relevant to a determination of the Company's primary business. Such a comparison on an annual, or other suitable basis, may be more revealing of a company's primary business than a comparison of the company's net gains or losses in futures and options on futures trading with its net gains or losses in investing in securities, otherwise than by reason of investing in futures and options on futures, which figures would be affected by the company's [*10] relative degree of success in these different areas.

We note that as previously indicated, n10 there is a ban against trading futures on individual corporate and muncipal securities and our position and interpretation does not apply to such interests.

n10 See discussion at p. 1 supra.

Based upon the foregoing, and in accordance with the terms of the accord and the legislation enacted pursuant hereto, we would not recommend that the Commission take any enforcement action under the following:

(A) the Investment Company Act if, without registering under the Act, Peavey Commodity Futures Funds I, II, and III (the "Funds") invest in (1) futures contracts on securities, which contracts were approved by the CFTC prior to the enactment of the Futures Trading Act of 1982 or are approved by the CFTC in conformance with the accord and the legislation embodying the accord, (2) futures contracts on stock indices, which contracts also were approved by the CFTC prior to inactment of the Futures Trading Act of 1982 or are approved by the CFTC in conformance with the accord and the embodying legislation, and (3) options on such futures contracts and options on physical commodities traded [*11] on contract markets designated by the CFTC (the interests mentioned in (1), (2) and (3) are referred to hereinafter as "approved futures and CFTC options"), and the Funds' trading advisers do not comply with section 15 of the Investment Company Act, provided that the Funds are not otherwise engaged in the business of investing in securities so as come with the definition of an investment company contained in section 3(a) of the Investment Company Act; and

(B) the Investment Advisers Act if, without registering under such Act, the Funds' trading advisers provide the Funds with advice concerning approved futures and CFTC options, provided that such advisers are not otherwise investment advisers as defined in the Investment Advisers Act who are required to register under the Investment Advisers Act.

Stanley B. Judd
Deputy Chief Counsel

INQUIRY-1: LAW OFFICES
ABRAMSON & FOX
ONE EAST WACKER DRIVE
CHICAGO, ILLINOIS 60601
(312) 644-8500
Investment Company Act
of 1940/Sections
2(a)(20); 2(a)(36);
3; and 8
Investment Advisers
Act of 1940/Sections
202(a)(11); 202(a)(12);
202(a)(18); 203; and
205
January 12, 1983

Office of the Chief Counsel
Division of Investment Management
Securities [*12] and Exchange Commission
450 5th Street, N.W.
Judiciary Plaza
Washington, D.C. 20549

Attention: Sidney L. Cimmet, Esq.

Re: Peavey Commodity Futures Fund I (No. 0-9497)
Peavey Commodity Futures Fund II (No. 0-10149)
Peavey Commodity Futures Fund III (No. 2-76259)

Gentlemen:

Peavey Commodity Futures Funds I, II and III (the "Funds") are public commodity pools organized in 1980, 1981, and 1982 respectively under the Illinois Uniform Limited Partnership Act. Units of limited partnership interest of each Fund were registered with the Securities and Exchange Commission (the "SEC") on Form S-1 and were offered to the public by registered broker-dealers who were members of the National Association of Securities Dealers, Inc. Each of the Funds was organized to engage in the speculative trading of commodity futures contracts and other commodity interests. Trading decisions for Peavey Commodity Futures Fund I and II are made by Elam Management Corporation and trading decisions for Peavey Commodity Futures Fund III are made by Dean Corporation. Both Elam Management Corporation and Dean Corporation (the "Advisors") are registered as commodity trading advisors with the Commodity [*13] Futures Trading Commission ("CFTC"). The general partner of the Funds is Peavey Futures Management Corporation ("PFMC"), a wholly-owned subsidiary of the commodity broker of the Funds, Peavey Company. PFMC is registered as a commodity pool operator, and Peavey Company is registered as a futures commission merchant with the CFTC.

The trading policies of the Funds restrict trading in financial instrument futures contracts to those five types of contracts specified in the "no-action" letter concerning Boston Futures Fund (I) issued by the Division of Investment Management on October 12, 1979 (Ref. No. 79-362-CC) (attached as Exhibit A). Trading in other financial instrument contracts is prohibited until the SEC no longer takes the position that trading in such contracts may require registration by the Funds under the Investment Company Act of 1940 and by the Advisors under the Investment Advisors Act of 1940 or until the matter, in the opinion of counsel to the Funds, has been settled by controlling precedent to the effect that such Acts are not applicable to such contracts (the Investment Company Act of 1940 and the Investment Advisors Act of 1940 are hereinafter referred to as [*14] "the 1940 Acts").

As a result of developments since the issuance of the Boston Futures Fund (I) no-action letter, including recent revisions to the securities and commodity laws, Peavey Commodity Futures Funds I, II and III and the Advisors respectfully request that the staff issue a "no-action" letter with respect to the non-registration of the Funds and the Advisors under the 1940 Acts as more fully described below. This firm is counsel to Peavey Commodity Futures Funds I, II and III and has been authorized to sign this letter on behalf of Townley & Updike, counsel to Elam Management Corporation and Dean Corporation.

Authorization and Consideration by CFTC of Additional Financial Instrument Contracts and Options

Since the issuance of the Boston Futures Fund (I) no-action letter in 1979, many additional financial futures contracts have been authorized by the CFTC for trading on designated contract markets (commodity exchanges). These include futures contracts on bank certificates of deposit, on Eurodollar certificates and, most recently, on broad-based stock indices. Numerous additional financial futures contracts have been proposed by commodity exchanges and are currently [*15] under review by the CFTC. In October, 1982, options on certain futures contracts began trading pursuant to a pilot option trading program approved by the CFTC. * Additional options contracts, including options on stock-index futures contracts, have been proposed by commodity exchanges and are currently under review by the CFTC.

* Under the pilot program, one type of options contract may be traded on each exchange. Currently, the Chicago Board of Trade trades options on Treasury Bond futures, the International Monetary Market of the Chicago Merchantile Exchange trades options on Treasury Bill futures, the Coffee, Sugar and Cocoa Exchange trades options on sugar futures, and the Commodity Exchange of New York and the Mid-America Commodity Exchange trade options on gold futures.

Commodity pools have been discouraged or even prohibited from participating in many of these newly authorized futures and options contracts because the no-action position of the SEC expressed in the Boston Futures Fund (I) letter was restricted to the five types of futures contracts listed therein (Treasury Bonds, Treasury Notes, Treasury Bills, GNMA certificates and commercial paper). This has had [*16] a significant impact on the commodity markets because commodity pools now provide an increasingly important means of public participation in the commodity markets. In addition, financial instrument contracts have had the greater growth in volume of any group of futures contracts and now constitute a substantial portion of total commodity futures volume.

Jurisdictional Accord between SEC and CFTC

On December 7, 1981, the SEC and the CFTC announced their agreement on a range of issues regarding their respective jurisdiction. The agencies have released a joint explanatory statement setting forth their proposed resolution of the jurisdictional confusion which had grown out of the proliferation of new securities and commodity products. This jurisdictional accord (attached as Exhibit B) was not only a pronouncement of the positions of the two agencies but also formed the basis for seeking Congressional ratification of the SEC-CFTC jurisdictional resolution.

In the accord, it was agreed that the SEC will regulate options on securities, on certificates of deposit, and on all indices of securities or certificates of deposit. The CFTC will regulate futures contacts on exempted [*17] securities (other than municipal securities) and on broad-based indices of any securities, as well as options on any such futures contracts. Both agencies agreed to specific standards governing CFTC designation of a contract market for futures on stock indices. Authority for regulation of foreign currency options would depend upon whether the trading took place on securities exchanges or in the commodity markets.

The jurisdictional accord is widely regarded as an important step toward defining the jurisdictional lines between the two asgencies. As described in the following section, Congress accepted the legislative proposals made by the two agencies and enacted legislation ratifying the substance of the accord.

Congressional Ratification of Jurisdictional Accord

In extensive hearings conducted in 1982, Congress considered the jurisdictional accord reached between the SEC and CFTC. Ratification of the accord would involve amendments to both the securities and commodity laws. As discussed below, Congress passed and the President signed legislation (H.R. 6156) amending the securities laws affected by the ratification of the jurisdictional accord. Corresponding revisions [*18] to the commodity laws were reported out of the Conference Committee, which also considered other amendments resulting from hearings held to consider the

reauthorization of appropriations for the CFTC. On January 11, 1983, President Reagan signed into law the Futures Trading Act of 1983, which incorporate those revisions to the commodity laws.

The principal revision to the securities laws in H.R. 6156 which has been enacted was to the definition of a "security." That definition, found in the Securities Act of 1933, Securities Exchange Act of 1934 and the 1940 Acts, now expressly includes

any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any pur, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency...

These amendments remove any doubt that the SEC has the authority to regulate options on securities, certificates of deposit, stock indices, and foreign currencies. The Futures Trading Act of 1982 complements these revisions to the securities laws by ratifying the jurisdictional accord with [*19] respect to exclusive CFTC authority to regulate futures contracts, including futures contracts on securities and stock indices, and options thereon.

The Futures Trading Act of 1982 amends Section 2(a)(1) of the Commodity Exchange Act by adding a new subparagraph (B)(ii) which grants to the CFTC exclusive jurisdiction:

with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty') and transactions involving, and may designate a board of trade as a contract market in, contracts of sale (or options on such contracts) for future delivery of a group or index of securities (or any interest therein or base upon the value thereof)...

The Futures Trading Act of 1982 specifies the guidelines for CFTC approval of such options and futures contracts. These guidelines give the SEC certain authority with respect to approval of a futures contract on a stock index (or option thereon) prior to trading of the contract. The legislative history to the Futures Trading Act of 1982 makes clear that the CFTC retains exclusive [*20] authority to regulate all aspects of trading in such contracts after such contracts are approved.

Under the Futures Trading Act of 1982, the CFTC would not be permitted to designate a contract market to trade futures contracts (or options thereon) on corporate or municipal securities. Currently there are no futures contracts or options contracts on corporate or municipal securities approved for trading. Consequently, all existing futures contracts and options contracts traded on commodity exchanges fall within the jurisdiction of the CFTC. There is no indication in the legislative history of the Futures Trading Act of 1982 or of H.R. 6156 that Congress intended existing futures contracts including futures contracts on securities to be regulated by te SEC. Accordingly, existing futures contracts approved for trading, including futures contracts on certificates of deposit and on Eurodollar certificates, would remain within the exclusive jurisdiction of the CFTC.

Need For No-Action Position

Since the issuance of the Boston Futures Fund (I) no-action letter, futures contracts on Eurodollar certificates, on certificates of deposit, and on stock indices as well as options [*21] on financial futures contracts have been authorized by the CFTC and are now traded on designated contract markets. In view of (i) the proliferation of new commodity contracts, (ii) the jurisdictional accord between the SEC and the CFTC, and (iii) statutory ratification of the accord, an extension of the Boston Futures Fund (I) no-action letter is appropriate. A no-action position would essentially reflect recent changes in the securities and commodity laws and, at the same time, would eliminate any inconsistencies and gaps between the new legislation and the Boston Futures Fund (I) no-action letter. Of course, pertinent provisions of the Commodity Exchange Act and regulations of the CFTC, including registration, disclosure, anti-fraud, and record-keeping requirements, would continue to apply to the Funds and the Advisors. In addition, the Securities Act of 1933 and the Securities Exchange Act of 1934 would continue to apply to the Funds.

Therefore, for the reasons stated, Peavey Commodity Futures Funds I, II and III and the Advisors respectfully request that the Division of Investment Management of the SEC issue a no-action letter to the effect that registration by the Funds [*22] and by the Advisors under the 1940 Acts is not required for trading in (i) futures contracts on securities which contracts have been approved by the CFTC or are approved by the CFTC in conformity with the jurisdictional accord and the legisation ratifying such accord, (ii) futures contracts on stock indices, and (iii) options on both futures contracts and physical commodities traded on contract markets designated by the CFTC. The provisions of *17 CFR § 200.81(a) (1978)* are hereby waived and the SEC is authorized to make this letter and its interpretive response public whenever its so chooses and without regard to the thirty day non-publication rule.

Very truly yours,
ABRAMSON & FOX
Mark H. Mitchell

INQUIRY-2: EXHIBIT B
Commodity Futures Trading Commission
Securities and Exchange Commission

JOINT EXPLANATORY STATEMENT

As announced on December 7, 1981, the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") have come to an agreement on a range of issues regarding their respective jurisdictions. In connection with this effort, the agencies have prepared draft legeslation which, amont other things, would clarify the statutes administered [*23] by the two agencies. The CFTC and the SEC are transmitting the draft legislative proposals to their respective Congressional committees, with this Statement, which explains a number of issues relating to the agreement. The two agencies urge that these statutory changes be enacted as promptly as possible.

The desirability of a resolution by the two agencies of the issues between them has become increasingly clear. The growing demand for new products related to securities of financial instruments, either as investments or as price hedging tools, has magnified the importance of removing the jurisdiction confusion that has hampered the development of the markets for such instruments. The confusion is a result essentially of amendments in 1974 to the Commodity Exchange Act (the "CEA") that (1) expanded the definition of "commodity" to embrace not only tangible goods but to reach intangible rights and interests, (2) gave the CFTC "exclusive jurisdiction" over agreements and transactions "involving" futures trading incommodities, and (3) inserted in the CEA a qualified proviso to preserve the SEC's preexisting authority over securities trading and the securities markets.

Summary [*24]

The two agencies have agreed that the SEC will regulte options on securities and on certificates of deposit (and on all groups or indices of securities or certificates of deposit) and the CFTC will regulate futures contracts on exempted securities (other than municipal securities) and on broad-based groups or indices of any securities, as well as options on any such futures contracts. No futures contracts (or options on futures contracts) on individual corporate and municipal securities will be permitted to trade. The SEC may also allow options on foreign currency to trade on national securities exchanges, while the CFTC will have jurisdiction to regulate the trading of options on foreign currency in the commodities markets. The attached legislative proposals would specifically codify the agreement of the two agencies by clarifying current law in certain areas.

Options on securities

Since 1973, national securities exchanges have traded options on securities under the regulatory structure administered by the SEC. The proposals to amend the federal securities laws would relate to the SEC's authority to regulate trading in options on securities. The SEC's authority over such [*25] trading on exempted securities has been challenged in the United States Court of Appeals for the Seventh Circuit. n1 Thus, one proposal would clarify the definition of "security" in the federal securities laws to include explicitly any option on a security. n2 In addition, options on foreign currency traded on a national securities exchange and options on certificates of deposit n3 would be included within that definition. Under the proposals, the SEC's authority over the trading of securities options also would be clarified by an amendment to Section 9(f) to establish specifically that the SEC's plenary options authority in Section 9(b) of the Exchange Act extends to options on exempted securities and by the addition of Section 9(g) which confirms the SEC's authority to regulate the trading of options on all securities and on certificates of deposit. The same legislative proposal would provide that only the SEC, and not the CFTC, has authority with respect to options directly on underlying securities and securities groups or indices.

n1 Board of Trade of the City of Chicago v. Securities and Exchange Commission, et al., No. 81-1660 (7th Cir., petition for review filed April 24, 1981), (No. 81-2587 (7th Cir., petition for review filed October 5, 1981); and No. 82-1097 (7th Cir., petition for review filed January 21, 1982).

n2 As a result, an option on an exempted security would expressly be a separate, non-exempted security. Accordingly, a person in the business of effecting transactions in such instruments would, absent an applicable exemption, be required, pursuant to Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act"), to

register with the SEC as a broker or dealer. To the extent, however, that such a requirement would impose an unnecessary burden on government securities dealers effecting transactions in options on government securities, the SEC has the authority administratively to provide an exemption from that requirement and currently intends to do so.

n3 Although the status of certificates of deposit as securities under the Securities Act of 1933 (the "Securities Act") and the Exchange Act is not free from doubt, certificates of deposit have consistently been considered "securities" for the purposes of the Investment Company Act of 1940. In order to emphasize that no change in current law is contemplated, the legislative language used in the two circumstances differs. Thus, for investment company purposes, the relevant portion of the definition of security would read "* * * option * * * on any security including a certificate of deposit," while the corresponding language proposed in the Securities and Exchange Act would read "* * * option * * * on any security, or certificate of deposit * * *."

[*26]

Under a series of proposed amendments to the federal commodity laws, the CEA would not apply to options on securities or securities aggregates, and the CFTC would not be permitted to designate a board of trade as a contract market for the trading of such instruments. Nevertheless, the CFTC would have exclusive jurisdiction over all permissible futures contracts as well as options on those futures contracts, and would regulate options directly of foreign currencies traded in the commodity markets (but not on a national securities exchange).

Futures on individual corporate or municipal securities

Pending further review of appropriate regulatory systems for trading in such futures, the legislative proposal would foreclose the trading of futures (and options on futures) on individual corporate or municipal securities, or contracts based on the value of such a security. Nevertheless, the two agencies intend to study further the issues raised by such trading with a view toward a future recommendation to lift this restriction. This temporary foreclosure of trading does not apply to futures (or options on futures) on exempted securities, except municipal securities.

Futures on [*27] securities indices

The CFTC would be permitted under proposed amendments to the CEA to designate a board of trade as a contract market for contracts (or options on such contracts) of sale for future delivery of a securities group or index, but only if the contract (or option on such contract) meets certain specific minimum requirements set forth in the draft legislation as well as other requirements currently in the CEA.

With respect to a futures contract on a securities group or index (or option on such contract), settlement must be effected in cash or by means other than a security on which a futures contract could not be authorized. That is, such a contract could be settled by delivery of an exempted security, such as a security issued or guaranteed by the United States government, but could not be settled by the transfer or receipt of a corporate or municipal security.

Separate and apart from the present statutory requirement that any contract market have rules to prevent manipulation, the CFTC also would be required to find that trading in the contract under consideration would not be likely to produce manipulation in the futures markets or in related markets, i.e., [*28] those for any underlying security, option on such security, or option on a group or index including such securities. n4

n4 In order to address concerns relating to the general possibility of inter-market manipulation, the agencies have recommended the CEA be amended to authorize the CFTC to provide trade information to securities self-regulatory organizations and to registered futures associations, as well as to contract markets.

A securities group or index underlying a futures contract must be predominantly composed of the securities of unaffiliated issuers and, in addition, would be required to be a widely published measure of, and to reflect, the market for all publicly-traded equity or debt securities or a substantial segment of such market, or be comparable to such a measure. This standard is intended to provide adequate flexibility for the market to respond to the needs of participants, while assuring that only broad-based securities index futures contracts that are not conductive to manipulation could be authorized. n5

n5 In practice, the two agencies believe that these standards will raise few substantial questions with respect to trading futures on established, widely-used indices containing a number of securities sufficient so that the indices will not be subject to manipulation. As one example, an index of most of the securities traded on a major national securities exchange would appear unlikely to present difficulties. Such indices also would seem more

likely to be useful to the marketplace, since they would permit persons such as underwriters or portfolio managers to hedge the risk of overall market movements. However, it appears unlikely that indices not now in existence, based on bonds issued by a group of affiliated companies or on small industry groups, would meet such standards.

[*29]

In view of the SEC's strong regulatory concern with respect to the trading of futures on securities groups and indices, that agency would be provided a specific role in the process of CFTC designation of a contract market for the trading of such instruments. n6 The CFTC would be required to consult with the SEC with respect to designation of any board of trade as a contract market for any futures contract involving a securities group or index. Following a mandatory public comment period, the SEC would be provided with a specific time period during which it could object to the designation on the ground that any minimum requirement was not met. If the SEC objected, the CFTC would, if the SEC requested, afford it an opportunity, after the public comment period, for an oral hearing prior to action upon the designation. After the oral hearing, if the SEC continued to maintain its objections, the CFTC would be required to give appropriate weight to the SEC's views in deciding whether to authorize the contract. If, nonetheless, the CFTC designated a board of trade as a contract market for such a futures contract, n7 the SEC would have the right to judicial review of such order, at [*30] which time the court would consider the CFTC's action and SEC's views. In reviewing the CFTC action, the court would be required to determine, in accodance with the standards of Section 6(b) of the CEA, whether the agency action was supported by the weight of the evidence.

n6 Section 2(a)(8) of the CEA provides a procedure for CFTC solicitation of comments from the U.S. Department of the Treasury and the Board of Governors of the Federal Reserve System ("FRB") with respect to futures contracts involving securities issued or guaranteed by the U.S. government. As agencies concerned with the issuance of such securities and with monetary policy and debt management, the Treasury Department and the FRB clearly have an interest in the CFTC designation of a market for futures on such instruments. Nevertheless, the SEC, as the regulator of trading markets in municipal and corporate securities, has an even more direct interest in the authorization of a related futures market. Thus, the involvement of the SEC in the designation process is intended to go beyond the relatively informal communications procedure established for the Treasury Department and the FRB.

n7 If the CFTC refused to grant the application for designation and, pursuant to the CEA, afforded the board of trade an opportunity for a hearing on the record, the SEC would have the right to participate in that hearing as an interested party. Thus, the SEC would be permitted to present evidence and its views and to challenge the arguments advanced by the board of trade in support of its application.

[*31]

Commodity pools

While the CFTC has adopted extensive regulations governing the activities of commodity pool operators and has exclusive jurisdiction with respect to "accounts * * * involving" futures, the SEC has taken the position that the activities of a commodity pool as a company, i.e., its formation, capital-raising, and continued corporate existence, are subject to the federal securities laws. The draft legislative language would make this result explicit by stating that nothing in the CEA affects the applicability of the Securities Act and the Exchange Act with respect to securities issued by commodity pools and transactions therein. Of course, the proposed language would not affect the exclusive jurisdiction granted by the CEA with respect to state regulation. Moreover, in appropriate circumstances, commodity pools and persons managing them may be subject to the Investment Advisors Act of 1940 and, if a pool conducts not only a commodities business but also acts as an investment company, the Investment Company Act of 1940.

SEC-REPLY-3: EXHIBIT A
October 12, 1979
RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 79-362-CC [*32]
Boston Futures Fund (1)
Registration Statement on
Form S-1 (No. 2-64952)

The term "Security", as defined in the Investment Company Act of 1940 ("Investment Company Act") and the Investment Advisors Act of 1940 ("Advisers Act"), includes a right to purchase a security. For this reason and others, a futures contract on a security may itself be deemed to be a security.

A company primarily engaged in investing in securities is an investment company subject to the provisions of the Investment Company Act, and a person who gives advice, for compensation, about securities is an investment adviser subject to the provisions of the Advisers Act.

The exclusive jurisdiction granted the Commodity Futures Trading Commission ("CFTC") by section 2 of the Commodity Exchange Act ("CEA") with respect to accounts, agreements, and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a designated contract market or any other board of trade, exchange, or market, and transactions with respect to leverage contracts, does not necessarily remove a fund which is primarily engaged in the business of investing in futures on securities, or a person who gives [*33] advice about such futures, from the provisions of other laws which are otherwise applicable to them, such as the securities laws.

Section 2 of the CEA provides that except for the exclusive jurisdiction granted the CFTC in the areas stated, nothing in that section shall supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws. In this regard, interests in the Fund have been registered under the Securities Act of 1933 ("1933 Act").

However, the Securities and Exchange Commission's traditional areas of regulatory concern, as opposed to antifraud concern, have not included United States Treasury Bills, United States Treasury Notes, United States Treasury Bonds, Government National Mortgage Association certificates, and commercial paper, all of which are exempt from the registration requirements and certain other provisions of the 1933 Act. For this reason, and in view of the purposes of the provisions [*34] of the CEA which are applicable to the Fund and to the Advisor, i.e., the regulation of commodity pool operators and commodity trading advisors, we would not recommend that the Commission take any action under the Investment Company Act or the Advisers Act against the Fund or the Advisor by reason of their proceeding as indicated and investing in, or giving advice with respect to, futures contracts on commodities without the Fund's registering under the Investment Company Act or the Advisor's registering under the Advisers Act. This position is conditioned on any investment by the Fund in futures contracts on financial instruments, and and advice given by the Advisor about futures contracts on financial instruments, being limited to futures contracts on United States Treasury Bills, United States Treasury Notes, United States Treasury Bonds, Government National Mortgage Association certificates, and commercial paper. Nothing contained in this letter should be construed to suggest that registration under the Investment Company Act or the Advisers Act would not be required if the Fund invested in, or the Advisor gave advice with respect to, futures contracts on any other type of security. [*35]

Stanley B. Judd
Assistant Chief Counsel

1332TZ

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1996 SEC No-Act. LEXIS 623

Investment Company Act of 1940 -- Section 3(b)(1)

July 15, 1996

[*1] Managed Futures Association

TOTAL NUMBER OF LETTERS: 2

SEC-REPLY-1: SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 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 [*2] 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. n1 You further represent that managing a single pooled account may help successful CTAs keep their trading strategies confidential.

n1 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 per-

formance over time simply due to order allocations. You represent that a single account eliminates inequities due to the order of trade allocations.

[*3]

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, n2 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). n3 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. n4

n2 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.

[*4]

n3 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).

n4 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.

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 [*5] of 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 [*6] 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. n5 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 trading in securities, either directly or through wholly-owned subsidiaries. n6

n5 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.

[*7]

n6 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).*

In Tonopah Mining Co. of Nevada ("Tonopah"), n7 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 [*8] 3(b)(2) of the Investment Company Act n8, the same factors are relevant to determining an issuer's primary business under Section 3(b)(1). n9 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.

n7 *26 S.E.C. 426 (1947).*

n8 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.

n9 See Investment Company Act Release No. 10937 (Nov. 13, 1979) (proposing Rule 3a-1), n.24.

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 position, therefore, that in determining the primary business [*9] 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. n10 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.

n10 Peavey Commodity Futures Fund (pub. avail. June 2, 1983) ("Peavey").

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 [*10] 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. n11

n11 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.

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. n12 Moreover, this response expresses the Division's [*11] views on enforcement action only and does not purport to express any legal conclusions on the questions presented. n13

n12 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 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.

n13 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.

[*12]

Phillip S. Gillespie
Senior Counsel

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

MANAGED FUTURES ASSOCIATION

GOVERNMENT RELATIONS: 1150 CONNECTICUT AVENUE, N.W., SUITE 700 . WASHINGTON D.C. 20036 . TEL: 202-872-9186 . FAX: 202-872-9189

July 11, 1996

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") n1 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 [*13] 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.

n1 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.

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 [*14] 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 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.

[*15] 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." n2 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 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.

n2 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.

[*16]

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 and monthly statements; and regulatory compliance and performance

computations are dramatically simplified. n3 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 [*17] 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.

n3 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.

It is not only the CTAs which benefit from "pooling" clients' funds. Investors themselves benefit from the reduced administrative costs, [*18] 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 [*19] 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 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 [*20] 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 [*21] 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 [*22] 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 [*23] 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
General Counsel
Director, Government Relations
Managed Futures Association

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts LawTypes of ContractsFuturesSecurities LawInvestment CompaniesGeneral OverviewSecurities LawU.S. Commodities Futures Trading CommissionFutures Contracts

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