



1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

April 12, 2011

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

Re: Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (RIN No. 3038-AD30)

Dear Mr. Stawick:

The Investment Company Institute¹ appreciates the opportunity to comment on the proposal by the Commodity Futures Trading Commission (“Commission” or “CFTC”) to modify or rescind several of its exemptive and exclusionary rules.² Our comments focus on the proposed amendments to CFTC Rule 4.5 that would apply solely to registered investment companies (“Rule 4.5 Proposal”).

ICI and its members strongly object to the Rule 4.5 Proposal in its current form. While we respect the Commission’s authority to “reconsider the level of regulation that it believes is appropriate with respect to entities participating in the commodity futures and derivatives markets,”³ we do not believe the Commission has demonstrated the need for a second level of regulation on registered investment companies, which are already subject to comprehensive regulation under the federal securities laws. We further believe that the Rule 4.5 Proposal is insufficiently developed and thus it is premature to adopt it at this time. It does not appear to reflect thorough consideration by the

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (“ETFs”), and unit investment trusts (“UITs”). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.0 trillion and serve over 90 million shareholders.

² *Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations*, 76 Fed. Reg. 7976 (Feb. 11, 2011) (“Release”).

³ *Id.* at 7977.

Commission of many critical issues, including how registered investment companies participate in the commodity futures and derivatives markets, the appropriateness of including swaps in the Rule 4.5 Proposal, the extensive regulation to which investment companies are subject under the Investment Company Act of 1940 (the “Investment Company Act”) and other federal securities laws, the overlapping and conflicting nature of many regulatory requirements that registered investment companies would face if they were regulated by both the Securities and Exchange Commission (“SEC”) and the CFTC, and the potential costs and burdens of dual regulation.

The Release states the Commission’s belief that the text of the proposed amendments to Rule 4.5 is “an appropriate point at which to *begin discussions* regarding the Commission’s concerns.”⁴ If, after reviewing the comments on the Rule 4.5 Proposal, the Commission nevertheless determines to proceed with amending Rule 4.5, we respectfully urge that the agency develop and issue a new proposal to amend the rule, taking into consideration the comments and recommendations that it receives in response to this Release. To assist the Commission in this endeavor, we have identified several critical issues that should be addressed in any proposal to amend Rule 4.5, and this letter sets forth our initial recommendations for how several of those issues might be resolved.

I. Executive Summary

Last summer, the National Futures Association (“NFA”) submitted a petition for rulemaking that asked the CFTC to narrow significantly the Rule 4.5 exclusion as applied to registered investment companies, by requiring compliance with certain trading and marketing restrictions. In late January, the CFTC proposed amendments to Rule 4.5 that not only incorporate the trading and marketing restrictions suggested in the NFA petition but also extend those restrictions to a fund’s positions in swaps. In the view of ICI and its members, the Rule 4.5 Proposal is overly broad in scope and would cause many registered investment companies to become subject to CFTC regulation, even though these funds do not raise the Commission’s stated concerns regarding “futures-only investment products.”

The CFTC has provided little rationale for its sweeping proposal, including why it is necessary to impose a second, costly layer of regulation on registered investment companies, which are already subject to comprehensive regulation under the Investment Company Act and other federal securities laws. Moreover, the proposal is insufficiently developed and adopting it without first resolving the many critical issues it raises would be premature. As a result, ICI and its members strongly recommend that, if the CFTC nonetheless determines to move forward with the Rule 4.5 Proposal, it publish for comment a revised version of the amendments that fully addresses these issues.

Our comments, concerns, and recommendations, which we describe fully below, include the following:

⁴ *Id.* at 7984 (emphasis added).

- **Including Swaps in the Rule 4.5 Proposal is Premature:** The Commission's inclusion of swaps in the Rule 4.5 Proposal has broad implications for a wide variety of registered investment companies, which may find it difficult or impossible to meet the proposed trading and marketing restrictions. While we do not question the CFTC's jurisdiction over swaps, we nonetheless believe it has an obligation under the Administrative Procedure Act ("APA") to explain the reasoning behind its decision to require these *users* of swaps to register. We also strongly believe that application of the Rule 4.5 Proposal to swaps is premature because the CFTC and SEC have not yet adopted rules specifying which swaps will be subject to central clearing and margin requirements have not been established for cleared or uncleared swaps. It also is still unclear whether foreign exchange swaps and foreign exchange forwards will be considered "swaps" subject to CFTC oversight. As a result, commenters are unable to provide meaningful input on this very critical aspect of the proposal.
- **Cost-Benefit Analysis:** We believe the CFTC's cursory cost-benefit analysis of the Rule 4.5 Proposal is inadequate to justify the costly and duplicative regulation that the proposal would impose on a large portion of the investment company industry. The analysis does not take into account many of the significant costs the proposal would impose on investment companies, and does not acknowledge the many protections shareholders currently benefit from under the Investment Company Act and other federal securities laws. We question whether the agency's analysis would satisfy applicable statutory requirements, and urge the CFTC not to adopt any amendments to Rule 4.5 without conducting a more comprehensive analysis.
- **Clarification Regarding Which Entity Would Register as a Commodity Pool Operator:** The Release does not state which entity would register as a commodity pool operator ("CPO") if a registered investment company is unable to meet the criteria for exclusion under amended Rule 4.5. Because the investment company's investment adviser is typically responsible for establishing the company and operating it on a day-to-day basis, we request that the CFTC concur with our view that the adviser is the appropriate entity to serve as the company's CPO.

- **Proposed Trading Restriction:** The proposed five percent limit on positions taken for non-bona fide hedging purposes, especially as it would apply to swaps, futures, and options used for non-speculative purposes, would result in a large number of registered investment companies being unable to rely on the Rule 4.5 exclusion. We believe that narrowing the scope of the trading restriction would be more consistent with the CFTC's regulatory goals, and offer the following suggestions: (1) eliminating or significantly narrowing the application of the proposed rule to swaps; (2) specifically referencing risk management as an element of "bona fide hedging" in the context of Rule 4.5; and (3) raising the threshold for positions taken for non-bona fide hedging purposes. We note, however, that it is not possible to comment on what the specific threshold should be until margin levels for swaps are determined.
- **Use of Wholly Owned Subsidiary Structure:** The Rule 4.5 Proposal would require that any instruments held for non-hedging purposes be held directly by the fund, and not through a wholly owned subsidiary, as funds investing in commodities often do today to avoid adverse tax consequences. We emphasize that this subsidiary structure is used by funds for legitimate tax purposes and not to evade regulation under the Investment Company Act. To address any remaining concerns the Commission may have, an investment company's adviser could make representations that it would make the books and records of the subsidiary available to the CFTC and NFA staff for inspection upon request and provide transparency about fees, if any, charged by the subsidiary.
- **Proposed Marketing Restriction:** The proposed language seeking to restrict the ability of registered investment companies to market themselves as "otherwise seeking investment exposure to" the commodity futures and options markets is phrased broadly and could pick up a wide variety of registered investment companies that have only a modest exposure to commodity futures, commodity options, and swaps (*e.g.*, asset allocation funds). We strongly believe this additional language in the marketing restriction is unnecessary and should be eliminated. In addition, we request clarification regarding the scope of the marketing restriction and confirmation that it would not be read so broadly as to apply to risk and other required disclosures in an investment company's registration statement or marketing materials.

- ***Areas of Conflict Between SEC and CFTC Regulation:*** Advisers to those registered investment companies that would be unable to meet the criteria for exclusion under proposed Rule 4.5 would be subject to both SEC and CFTC regulation, potentially resulting in duplicative regulation in many areas, as well as conflicting requirements in others (*e.g.*, relating to disclosure documents, delivery obligations, presentation of performance data, and operational requirements). We strongly believe that investment companies should not be subject to duplicative regulation and that any conflicts between the regulatory requirements should be resolved by the CFTC and SEC *before* amendments to Rule 4.5 are adopted. In fact, to satisfy the requirements of the APA, the CFTC must provide affected entities with notice of how they would be expected to comply, or how conflicting regulations would be resolved, and an opportunity to provide comment before any amendments to Rule 4.5 are finalized.

II. The Proposed Amendments to Rule 4.5 are Insufficiently Developed, and Adoption Would Be Premature

A. Background

The term CPO is broadly defined in the Commodity Exchange Act and generally includes, among other things, any person engaged in a business that is in the nature of an investment trust who receives funds from others “for the purpose of trading in any commodity for future delivery on or subject to the rules of a contract market or derivatives transaction execution facility.”⁵ CFTC Rule 4.5 recognizes the breadth of this definition, and provides an exclusion from CPO registration for certain persons operating “qualifying entities” that are subject to a different regulatory framework, including registered investment companies.⁶ Previously, the Rule 4.5 exclusion was conditioned upon the entity satisfying certain conditions relating to its trading in commodity interests and the marketing of shares/participations in the entity. After lengthy consideration in 2002-03 (which included an advance notice of proposed rulemaking and a public roundtable on the regulation of CPOs and commodity trading advisors (“CTAs”)), the CFTC determined to eliminate those conditions from the rule. In so doing, it cited, among other things, the fact that many qualifying entities avoided participation in the markets for commodity futures and commodity options because the Rule 4.5 conditions were “too restrictive for many [of them] to meet” and that facilitating participation in the commodity markets by additional collective investment vehicles and their advisers would have “the added benefit to all market participants of increased liquidity.”⁷

⁵ Section 1a(5) of the Commodity Exchange Act.

⁶ Entities seeking to rely on the Rule 4.5 exclusion must file a notice of eligibility with the National Futures Association that includes certain representations.

⁷ See *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors*, 68 Fed. Reg. 12622, 12626 (March 17, 2003) (“2003 Proposing Release”); *Additional Registration and Other Regulatory*

Last summer, the NFA submitted a rulemaking petition to the CFTC to amend Rule 4.5.⁸ According to the petition, the NFA had concerns about the marketing practices of three registered investment companies offering so-called “managed futures strategies.” The NFA petition proposed that the Rule 4.5 exclusion should be significantly narrowed for all registered investment companies, leaving other “qualifying entities” unaffected. Specifically, the petition recommended that registered investment companies should be required to comply with trading and marketing restrictions that are based upon those in the rule prior to 2003, but are actually much broader in scope.

Following publication of the NFA petition in the fall, the CFTC received considerable feedback from individual companies and trade and bar associations, including ICI (“October Letter”).⁹ Many of the comment letters expressed serious concerns about the scope of the NFA’s proposed language, outlined the difficulties that registered investment companies would face in trying to comply with overlapping and conflicting requirements of the CFTC and SEC, and offered possible solutions.

In late January, the CFTC voted to issue the Rule 4.5 Proposal. The agency drew the proposed rule text almost verbatim from the NFA petition, but significantly also applied the proposed trading and marketing conditions to a registered investment company’s positions in swaps. The Release contains little explanation for the proposed language, except to describe it as “an appropriate point at which to begin discussions regarding the Commission’s concerns.”¹⁰ The Release also does not address the considerable comments the CFTC received on the NFA petition, except to the extent it poses specific questions for further public comment based on the responses it received regarding the NFA petition.

B. The CFTC Has Not Demonstrated the Need for Imposing a Second Layer of Regulation on Registered Investment Companies

The CFTC provides little rationale in the Release for its sweeping Rule 4.5 Proposal. It is not mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), although the CFTC describes the Rule 4.5 Proposal as being “consistent with the *tenor*” of that Act.¹¹

Relief for Commodity Pool Operators and Commodity Trading Advisors: Past Performance Issues, 68 Fed.Reg. 47221 (Aug. 8, 2003) (“2003 Adopting Release”).

⁸ *Petition of the National Futures Association, Pursuant to Rule 13.2, to the U.S. Commodity Futures Trading Commission to Amend Rule 4.5*, 75 Fed. Reg. 56997 (Sept. 17, 2010).

⁹ Letter from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, CFTC, dated Oct. 18, 2010.

¹⁰ Release, *supra* note 2 at 7984.

¹¹ Release, *supra* note 2 at 7977 (emphasis added). See Letter from Scott Garrett, Chairman, Subcommittee on Capital Markets and Government Sponsored Enterprises, to Gary Gensler, Chairman, CFTC, dated March 3, 2011 (“Garrett

According to the Release, the proposed restrictions under Rule 4.5 are intended to “stop the practice of registered investment companies offering futures-only investment products without Commission oversight” and that “such restrictions would limit the possibility of entities engaging in regulatory arbitrage whereby operators of otherwise regulated entities that have significant holdings in commodity interests would avoid registration and compliance obligations under the Commission’s regulations.”¹² The CFTC provides no evidence, however, that such registered investment companies are currently subject to inadequate regulation, or that investors or the commodity markets generally have been harmed by their practices. Nor does the agency explain why the Rule 4.5 Proposal is troublingly broader in reach than “futures-only investment products,” as it potentially captures registered investment companies with relatively little exposure to the commodity markets.

As we discussed in the October Letter, investment companies are already extensively regulated under the Investment Company Act and other federal securities laws. The protections afforded under the securities laws include, among others:

- Limits on the use of leverage
- Antifraud provisions
- Comprehensive disclosure to investors, including with regard to:
 - Fees and expenses
 - The investment objectives and strategies of the investment company
 - The risks of investing in the investment company
- Independent board oversight
 - Particular emphasis on potential conflicts of interest
- Restrictions on transactions with affiliates
- Requirements regarding custody of fund assets

Importantly, the existing regulatory scheme for registered investment companies is, first and foremost, concerned with investor protection, and is administered by the SEC, for which the protection of investors is central to its mission. In addition, investment advisers to registered investment companies must themselves be registered with the SEC and be subject to regulation under the Investment Advisers Act of 1940 and related SEC rules, which also include antifraud protections. The Financial Industry Regulatory Authority (“FINRA”) also has oversight authority over an investment company’s principal underwriter and distributing broker-dealers. Also, even though excluded under current Rule 4.5, registered investment companies are subject to CFTC large trader reporting requirements like any other trader, which enables the CFTC to obtain information from

Letter”) (Congressman Garrett recently expressed concern regarding “the CFTC in many cases . . . going even beyond what the [Dodd-Frank Act] requires.”).

¹² Release, *supra* note 2, at 7984.

those entities that it can use to assess systemic risk.¹³ As a result, we continue to question why the CFTC believes it is necessary to impose an additional, costly layer of regulation on these already heavily-regulated entities.

C. The CFTC Has Failed to Justify its Proposed Disparate Treatment for Registered Investment Companies

Currently, the Rule 4.5 exclusion is available to a variety of “otherwise regulated entities.” The increased restrictions contemplated by the Rule 4.5 Proposal, however, would apply only to one type of entity that currently may rely on the rule – registered investment companies. Under this proposal, the full range of CFTC and NFA rules and oversight would be imposed *only* on registered investment companies that engage in commodity trading and are unable to satisfy the heightened criteria under Rule 4.5.

The Release offers no justification for imposing additional burdens on registered investment companies that, ironically, are subject to far more regulation and oversight than are other entities offered to, or operated for the benefit of, retail investors that may continue to rely on Rule 4.5 in its current form and thus be subject to only a single regulatory scheme. Such disparate treatment is an invitation to regulatory arbitrage, because there would be nothing in Rule 4.5 to preclude other qualifying entities from offering a “futures only” investment pool without CFTC oversight. The creation of this regulatory “gap” would be wholly inconsistent with the tenor of the Dodd-Frank Act. It also would be completely at odds with the Commission’s stated concerns in issuing the proposal.

Should the CFTC determine to modify Rule 4.5 to treat registered investment companies differently than other regulated entities that qualify for the Rule 4.5 exclusion, it must issue a reproposal that explain the basis for such disparate treatment as required by the APA.¹⁴

¹³ See Parts 15-19 and 21 of the CFTC’s regulations.

¹⁴ In *The Connecticut Light and Power Company, et al. v. Nuclear Regulatory Commission*, 673 F.2d 525 (D.C. Cir. 1982) (“*Connecticut Light*”), the Court of Appeals for the D.C. Circuit stated as follows:

The purpose of the comment period [required under the Administrative Procedure Act] is to allow interested members of the public to communicate information, concerns, and criticisms to the agency during the rule-making process. If the notice of proposed rule-making fails to provide an accurate picture of the reasoning that has led the agency to the proposed rule, interested parties will not be able to comment meaningfully upon the agency’s proposals. As a result, the agency may operate with a one-sided or mistaken picture of the issues at stake in a rule-making. . . . An agency commits serious procedural error when it fails to reveal portions of the technical basis for a proposed rule in time to allow for meaningful commentary. (Internal citations omitted).

D. The Proposed Inclusion of Swaps Under Rule 4.5 is Premature

As noted above, the Release states that the language from the NFA petition is “an appropriate point at which to begin discussions,” and the text of the proposed amendments to Rule 4.5 is drawn almost verbatim from the NFA petition. The text differs from the NFA’s language, however, in one key respect – by including swaps within the scope of the proposed trading and marketing restrictions. While we understand that the CFTC obtained jurisdiction over swaps as a result of the Dodd-Frank Act, its expanded jurisdiction does not relieve the agency of its obligation under the APA to explain the reasoning behind its proposal, including a clear rationale as to why *users* of swaps need to be registered.¹⁵ This includes the obligation to evaluate whether particular uses of swaps raise the concerns that Rule 4.5 is intended to address. Both analyses are entirely absent in the Release. As we cautioned in our October Letter, and as explained more fully below, the inclusion of swaps significantly expands the scope of the Rule 4.5 Proposal and would create a host of (presumably) unintended consequences. Including swaps in the proposal also would increase significantly the number of entities that would become subject to CFTC regulation at a time when the Commission has expressed concern that its resources are inadequate to meet its expanded regulatory responsibilities for swaps under the Dodd-Frank Act.¹⁶

As described in more detail below, the Rule 4.5 Proposal includes a condition that a registered investment company may use commodity futures, commodity options or swaps solely for “bona fide hedging purposes.” It may, however, hold certain instruments not for bona fide hedging purposes, if the initial margin and premiums required to establish those positions do not exceed five percent of the fund’s liquidation value.

¹⁵ See *id.* Section 553 of the APA requires that an agency provide the public with adequate notice of the substance of a proposed rule and an opportunity to provide meaningful comment. If it fails to do so, the resulting rule may be struck down by courts on the basis that it is not a “logical outgrowth” of the agency’s proposal. See *Kooritzky v. Reich*, 17 F.3d 1509, 1513 (D.C. Cir. 1994) (court stated that “agencies must include in their notice of proposed rulemaking ‘either the terms or substance of the proposed rule or a description of the subjects and issues involved’ . . . [a]nd they must give ‘interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments.’ The Labor Department did neither.” (internal citations omitted)) (“*Kooritzky*”); *Shell Oil Co. v. EPA*, 950 F.2d 741, 751 (D.C. Cir. 1992) (“an unexpressed intention cannot convert a final rule into a “logical outgrowth” that the public should have anticipated. Interested parties cannot be expected to divine the [agency’s] unspoken thoughts.”) (“*Shell Oil*”).

¹⁶ See Gary Gensler, Chairman, CFTC, Remarks, *Implementing the Dodd-Frank Act*, at FIA’s Annual International Futures Industry Conference, Boca Raton, Florida (March 16, 2011) (“Our current funding level of \$169 million is simply not sufficient for the CFTC’s expanded mission to oversee both the futures and swaps markets. Though we will work very closely with the National Futures Association, and they will take on as many responsibilities as they can, including those related to registration and examination of swap dealers, we will need significant resources to properly oversee both the futures and swaps markets.”) (“Gensler Remarks”).

As applied to swaps, this is a clear example of “cart before the horse” rulemaking¹⁷ and could be subject to challenge under the APA. The CFTC and SEC have not yet finalized rules regarding which swaps will be subject to central clearing requirements. Margin requirements have not yet been established for cleared or uncleared swaps and, once they are established, could vary significantly based on the type of swap. Similarly, we do not yet know whether the Department of the Treasury will exempt foreign exchange forwards and foreign exchange swaps from the definition of “swap”¹⁸ and, if no exemption is granted, what the margin requirements will be for these instruments. Given these uncertainties about swaps, *it is simply not possible for funds to evaluate in any meaningful way how they would fare under the proposed 5 percent trading restriction*, which is calculated on the basis of initial margin, or to determine whether a higher percentage threshold might be more appropriate. The new regulatory framework for swaps must be put in place and margin requirements for both centrally cleared and uncleared swaps established *before* any amendments to Rule 4.5 that implicate the use of swaps can be considered. Adopting the proposed amendments prior to that time would not provide the public with adequate notice of the substance of the rule the Commission intends to adopt, or an opportunity to provide meaningful comment.¹⁹

E. Harmonizing the Regulations That Would Apply to a Registered Investment Company Subject to CFTC Oversight Must Be Done Through Public Notice and Comment

As we explain in detail later in this letter, adoption of the Rule 4.5 Proposal could subject a large number of registered investment companies to regulation by the CFTC in addition to the SEC. As noted in our October Letter, this would make funds subject to many directly conflicting, or fundamentally inconsistent, requirements under the Investment Company Act and the Commodity Exchange Act. The Release states that dual regulation of registered investment companies “may result in operational difficulties” and seeks comment regarding “which rules and regulations are in conflict” and “how these could be best addressed by the two Commissions.”²⁰

While we are pleased that the CFTC recognizes the need to work cooperatively with the SEC in order to determine how their respective regulations should be harmonized for dual registrants, we are concerned that the Commission provides no guidance in the Release on how that might be accomplished. In order to meet the notice and comment requirements of the APA, we strongly believe that the agency must repropose the rule to include a detailed proposal regarding how registered

¹⁷ See Garrett Letter, *supra* note 11 (questioning the CFTC’s “cart before the horse” approach to rulemaking, and whether it “depriv[es] the public of the opportunity to provide meaningful comment on the CFTC’s proposals . . .”).

¹⁸ See Section 1a(47)(E) of the Commodity Exchange Act, as amended by the Dodd-Frank Act.

¹⁹ See *Connecticut Light*, *supra* note 14; *Kooritzky*, *supra* note 15; *Shell Oil*, *supra* note 15.

²⁰ Release, *supra* note 2, at 7984.

investment companies will be expected to comply with the CFTC's regulations, and how conflicting or inconsistent regulations will be reconciled.²¹ To proceed otherwise would deprive registered investment companies (and the broader public) of a meaningful opportunity to comment on the new regulatory requirements that would be placed on registered investment companies.²²

F. The CFTC Has Given Inadequate Consideration to the Potential Costs and Benefits of the Proposed Amendments to Rule 4.5

In our view, the CFTC's cursory cost-benefit analysis of the Rule 4.5 Proposal is inadequate to justify the costly and duplicative regulation that the proposal would impose on a large portion of the investment company industry.²³ In terms of costs, the agency identifies only the following as being relevant to the Rule 4.5 Proposal: (1) failing to adopt revisions to Rule 4.5 that are substantively similar to those proposed in the NFA's petition would result in disparate treatment of similarly situated collective investment schemes;²⁴ (2) requiring the filing of an annual notice to claim exemptive relief under Rule 4.5 enables the CFTC to better understand the universe of entities claiming relief from its regulatory scheme; and (3) the proposed changes "may result in additional costs to certain market participants due to registration and compliance obligations."²⁵ We strongly believe that the Rule 4.5 Proposal would impose additional, significant costs on registered investment companies. These costs—some of which would inevitably get passed on to shareholders—would include, among others:

- The cost of registering the CPO with the CFTC, and preparing for and taking additional licensing examinations (fund distributors are already subject to licensing requirements);
- The cost of preparing and distributing required disclosure documents and reports to investors (funds already provide substantial disclosures to their investors; what would be required by the CFTC's proposal would be different in form and timing, but for the most part would not provide meaningful additional information that investors currently lack);
- The cost of retaining counsel to attempt to reconcile and satisfy inconsistent regulatory requirements;

²¹ See *Kooritzsky*, *supra* note 15, at 1513 ("Something is not a logical outgrowth of nothing."); *Shell Oil*, *supra* note 15.

²² *Id.*; *Connecticut Light*, *supra* note 14.

²³ Release, *supra* note 2, at 7988.

²⁴ It is highly perplexing that the CFTC specifically lists this as a cost, given that its Rule 4.5 Proposal *fails* to include all "otherwise regulated" entities that are able to rely on the rule.

²⁵ Release, *supra* note 2, at 7988.

- The costs to upgrade systems to produce reports, coordinate and potentially develop new systems for vendors that currently assist in distributing investment company reports;
- The costs of training salespeople;
- The costs associated with the hiring and training of in-house counsel and compliance professionals, and costs associated with changes to fund compliance programs (both in terms of time spent by in-house personnel and fees paid for legal advice); and
- Even for those entities able to comply with the new Rule 4.5 restrictions on trading and marketing, the costs of having to establish the monitoring and compliance controls necessary to ensure their ongoing compliance with any trading restrictions.²⁶

With regard to benefits, the CFTC's analysis is equally insufficient, appearing to focus more on benefits stemming from other aspects of the Release rather than from the Rule 4.5 Proposal. Specifically, it notes the anticipated benefits of the increased information that proposed Forms CPO-PQR and CTA-PR would provide.²⁷ These benefits do not make sense in the context of registered investment companies, which are already heavily regulated by the SEC and are required to provide extensive and detailed disclosure that is available both to the public and to regulators. Moreover, the CFTC fails to acknowledge in its analysis that any benefits that investment company shareholders may receive as a result of the Rule 4.5 Proposal would largely be duplicative of the many protections they currently enjoy as a result of the Investment Company Act and other federal securities laws.

For these reasons, we have deep concerns as to whether the CFTC's analysis would satisfy the applicable requirements of the Commodity Exchange Act, and we urge that the agency not adopt any amendments to Rule 4.5 without conducting a more comprehensive analysis.²⁸ We further question

²⁶ Based on registered investment companies' experience with Rule 4.5 prior to its amendment in 2003, these controls would likely include consultations with legal counsel to determine whether or not a particular position would come within the applicable trading restrictions.

²⁷ The CFTC states that "the proposed changes . . . will [provide] the Commission and other policy makers with more complete information about these registrants. . . . the Commission does not have access to this information today and has instead made use of information from other, less reliable sources." Release, *supra*, note 2, at 7988.

²⁸ Section 15(a) of the Commodity Exchange Act requires the CFTC to consider the costs and benefits of its actions before issuing rules, regulations or orders. Section 15(a)(2) requires the CFTC to evaluate the costs and benefits in light of the following five areas: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. Both the CFTC's own Commissioners and members of Congress have recently raised concerns regarding the inadequacies of the CFTC's cost-benefit analyses in its recent proposals. *See, e.g.*, Commissioner Jill E. Sommers, Opening Statement, Meeting on the Twelfth Series of Proposed Rulemakings under the Dodd-Frank Act (Feb. 24, 2011) (" . . . the proposals we have voted on over the last several months [] contain very short, boilerplate 'Cost-Benefit Analysis' sections. . . . how can we appropriately consider costs and benefits if we make no attempt to quantify what the costs are? . . . Clearly, when it comes to cost-benefit analysis the Commission is merely complying with the absolute minimum

whether it is even possible for the CFTC to conduct an adequate analysis until the status and margin issues regarding swaps, discussed above, have been resolved, as the resolution of those issues could vastly impact the number of registered investment companies that may be swept into the CFTC's jurisdiction.

III. The CFTC Must Address Many Complex and Interrelated Issues in Developing a Proposal to Amend Rule 4.5

As is clear from our foregoing comments, we strongly object to the CFTC's proceeding with the Rule 4.5 Proposal, as it has not demonstrated a sufficient need to capture a broad swath of already highly regulated entities and subject them to CFTC regulation. In the event the CFTC determines to pursue this concept, however, we offer below some suggestions for crafting the proposal to better fit the agency's stated regulatory goal of protecting investors in pools offering "futures-only investment products." Any revisions to the proposal to make it consistent with that goal would need to be significant, and we respectfully request that the Commission provide the public with a meaningful opportunity to comment on such a revised proposal.

A. Clarification Regarding Which Entity Would Register as a Commodity Pool Operator

The Proposal is silent regarding which entity would register as CPO if a registered investment company is unable to meet the criteria for exclusion under amended Rule 4.5. In light of the structure and operations of registered investment companies, we request that the CFTC concur with our view that the registered investment adviser to such an investment company is the appropriate entity to serve as the company's CPO, and not the investment company itself or its directors (for a company organized as a corporation) or trustees (for a company organized as a trust) (together, "directors"). We believe having the adviser register as CPO under these circumstances will satisfy the CFTC's regulatory interest in ensuring that investors receive appropriate disclosure and reports, and that adequate records are maintained and available for regulatory inspection.²⁹

requirements of the Commodity Exchange Act. That is not in keeping with the spirit of the President's recent Executive Order on 'Improving Regulation and Regulatory Review.' We owe the American public more than the absolute minimum."); Letter from Frank D. Lucas, Chairman, Committee on Agriculture, and K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk Management, to A. Roy Lavik, Inspector General, CFTC, dated March 11, 2011 ("... recent public comments indicate that the CFTC is failing to adequately conduct cost-benefit analysis – either as required by the [Commodity Exchange Act] or the principles of the Executive Order [on Improving Regulation and Regulatory Review]. . . . Particularly during tough economic times, it is incumbent upon the CFTC to approach cost-benefit thoroughly and responsibly to understand the costs, and therefore the economic impact any proposed regulation will have on regulated entities and markets.").

²⁹ We note that while a registered investment adviser serving as CPO for a registered investment company would also be the investment company's CTA, regulations under the Commodity Exchange Act specifically acknowledge that an investment pool's CPO and CTA can be the same entity. See Rule 4.14(a)(4) under the Commodity Exchange Act (exemption from

The CFTC has indicated that the following factors may be relevant to determining who is acting as a CPO of a pool:

- Who is promoting the pool by soliciting, accepting or receiving from others, funds or property for the purpose of commodity interest trading;
- Who has the authority to hire (and to fire) the pool's CTA; and
- Who has the authority to select (and to change) the futures commission merchant ("FCM") that will carry the pool's commodity interest trading account.³⁰

In applying these factors in the registered investment company context, it is apparent that an investment company's adviser is the primary force in establishing and operating the company and the most logical person to serve as its CPO. A registered investment company has no employees and relies on its adviser for the day-to-day management of, and decisions regarding, the company. For example, it is typically the adviser that makes the decision to establish the investment company and, as the investment company's initial shareholder, typically selects its initial board of directors. The adviser also selects and recommends, for the board's approval, the investment company's service providers, which may include sub-advisers, a principal underwriter, custodians, a transfer agent, and an audit firm. It is the adviser that has the authority to select and change the investment company's FCM. Although employees of the adviser cannot, in their capacity as advisory employees, solicit investors to invest in the investment company, this function is typically served by the investment company's principal underwriter, often an affiliate of the adviser.³¹ The adviser has a fiduciary duty to the registered investment company, and is required to act in the best interests of the company and its shareholders.³²

By contrast, an investment company's directors do not perform functions that should require them to register or be subject to regulation as CPOs.³³ They serve an oversight role and are not responsible for the day-to-day management or operation of the investment company. The CFTC and

registration as a CTA for a person that is registered under the Commodity Exchange Act as a CPO, where the person's commodity trading advice is directed solely to, and for the sole use of, the pool or pools for which it is so registered).

³⁰ See *Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons From the Definition of the Term "Commodity Pool Operator"; Other Regulatory Requirements*, 50 Fed.Reg. 15868 (Apr. 23, 1985) ("1985 Adopting Release").

³¹ The principal underwriter is a registered broker-dealer. Its employees that engage in solicitation activities are registered representatives and hold appropriate licenses. As a result, an employee of the adviser that is also a registered representative of the principal underwriter can only engage in solicitation activities in his or her capacity as a registered representative, and not an advisory employee.

³² See Sections 36(a) and 36(b) of the Investment Company Act.

³³ See Letter from Dorothy A. Berry, Chair, IDC Governing Council, to David A. Stawick, Secretary, CFTC (Apr. 12, 2011).

its staff have recognized that registration of directors as CPOs may not be practicable or necessary.³⁴ The directors do not solicit investors for the investment company. The board's role is to oversee the performance of the investment company's adviser and other service providers under their respective contracts and monitor potential conflicts of interest. Under the Investment Company Act, an investment company's board of directors must generally be comprised of a majority of "independent" directors. In order to be considered "independent" under the Investment Company Act, these directors generally may not have a significant business relationship with the fund's adviser, principal underwriter, or affiliates.³⁵ As the Supreme Court has recognized, these independent directors are responsible for looking after the interests of the fund's shareholders and serve as "independent watchdogs" who "furnish an independent check" upon the management of the fund.³⁶ While the directors have the authority to approve and terminate the investment company's agreement with its adviser, termination is a drastic step. Such an action is not only costly and disruptive, but also contrary to the investment company shareholders' express intention to invest with a particular manager. Requiring registration of directors would be fundamentally inconsistent with their oversight role; subjecting them to the requirements applicable to CPOs when they do not perform the functions of a CPO would be unnecessary and would not further investor protection.

We also believe that it is not appropriate for the registered investment company to register as CPO. The CFTC generally takes the position that a CPO and its pool must be separate legal entities.³⁷ As noted above, a registered investment company has no employees and relies on its adviser for the day-to-day management of, and decisions regarding, the company. It is the registered investment adviser, not the investment company, which performs the functions that are key to being deemed a CPO and is responsible for the investment company's operations. It is appropriate, therefore, that the fund's adviser should register solely with respect to the funds it manages. This approach would be consistent with the CPO/pool model, in which it is the pool's operator that registers with the CFTC, not the pool itself.

If you concur with our view that the adviser to a registered investment company is the entity that should register as CPO, only those registered investment companies or other pools managed by the

³⁴ See, e.g., *Commodity Pool Operators: Relief From Compliance With Certain Disclosure, Reporting and Recordkeeping Requirements for Registered CPOs of Commodity Pools Listed for Trading on a National Securities Exchange; CPO Registration Exemption for Certain Independent Directors or Trustees of These Commodity Pools*, 75 Fed.Reg. 54794 (Sept. 9, 2010) (proposing exemptive relief from CPO registration for directors of exchange traded commodity funds that were not registered investment companies) ("Commodity ETF Release"); CFTC Staff Letter No. 10-06 (March 29, 2010).

³⁵ An independent director also cannot own any stock of the investment adviser or certain related entities, such as parent companies or subsidiaries. See Section 2(a)(19) of the Investment Company Act.

³⁶ *Burks v. Lasker*, 441 U.S. 471, 484 (1979).

³⁷ See Rule 4.20(a) under the Commodity Exchange Act.

adviser that are not eligible for exclusion under Rule 4.5 would become subject to CFTC regulation.³⁸ In addition, if the CFTC deemed it appropriate, it could require an investment company adviser that must register as a CPO to amend its advisory agreement at its next annual contract renewal to state that the adviser will serve as the investment company's CPO and to notify investment company shareholders of this change in the investment company's next annual prospectus update.

The CPO registration process would provide the CFTC with additional information about the adviser, its principals, including any principals of the adviser that also serve as directors of investment companies managed by the adviser, and any associated person(s). An adviser registering as a CPO would include Form 8-Rs for its natural person principals and associated persons, including those investment company directors who are principals and/or associated persons of the adviser. The adviser also would submit, on behalf of those persons, a fingerprint card. We note that, under the Investment Company Act, all of the investment company's directors, including the independent directors, are subject to statutory disqualification provisions, which are similar to those under the Commodity Exchange Act.³⁹

One of the adviser's executive officers would serve as the associated person of the CPO. We believe it is appropriate for an adviser CPO to have only one associated person for purposes of its CPO registration because, as discussed above, the adviser cannot solicit investors for the registered investment company. Instead, that function is performed by registered representatives of the registered investment company's principal underwriter, who hold Series 7 licenses.⁴⁰ Rule 3.12(a) under the Commodity Exchange Act generally requires that any person associated with a CPO be registered under the Commodity Exchange Act as an associated person, which typically requires passing the Series 3 examination. Rule 3.12(h)(1)(ii), however, provides that if the pool is offered by registered representatives that are associated with broker-dealers that are registered under the Securities Exchange Act of 1934, the registered representatives are exempt from the Series 3 licensing requirement. The registered representatives of the fund's principal underwriter would rely on this exemption to sell the fund's shares. Because it is the fund's principal underwriter, and not the adviser, that offers and sells the fund's shares, we believe it would be appropriate for the associated person of the adviser to satisfy his or her licensing requirement by passing the Series 31 examination rather than the Series 3 examination, and plan to request such relief from the NFA.⁴¹

³⁸ We note that the CFTC has recognized that separate funds should be treated separately for purposes of determining whether the criteria for exclusion under the rule have been met. *See, e.g.*, 1985 Adopting Release, *supra* note 30, at II.B.

³⁹ *See* Section 9 of the Investment Company Act.

⁴⁰ A Series 7 license is designed to ensure that the holder has an understanding of the concepts relating to solicitation, purchase, and/or sale of all securities products, including corporate securities, municipal securities, municipal fund securities, options, direct participation programs, investment company products, and variable contracts.

⁴¹ We believe the Series 31 examination is better tailored to the adviser's limited activities in this regard than the Series 3 examination, which requires knowledge of general commodity-related topics.

B. Scope of the Trading Restrictions in the Rule 4.5 Proposal

As indicated above, the overly broad nature of the Rule 4.5 Proposal in its current form would implicate many registered investment companies beyond the “futures-only” funds referred to in the Release. This point is illustrated by preliminary data from several ICI member complexes, discussed below. In particular, the data suggest that many types of registered investment companies use swaps, futures, and options as a means to efficiently manage their portfolios, rather than as part of operating a commodity fund. As a result, we believe that the CFTC should revise the scope of the Rule 4.5 Proposal in a manner that acknowledges that registered investment companies’ use of these instruments for non-speculative purposes does not raise the concerns that the Rule 4.5 Proposal is designed to address.

We begin with a brief discussion of how registered investment companies use futures, options and swaps. Next, we present the member data described above. Finally, we offer several suggestions for how the CFTC might appropriately narrow the scope of the trading restrictions in the Rule 4.5 Proposal, including by: (1) eliminating or significantly narrowing the application of the proposed rule to swaps; (2) specifically referencing risk management as an element of “bona fide hedging” in the context of Rule 4.5; and (3) raising the threshold for the Non-Hedging Restriction.

1. Use of Commodity Futures, Commodity Options and Swaps by Registered Investment Companies

Registered investment companies use commodity futures, commodity options and swaps in a variety of ways to manage their investment portfolios, and many of these uses are unrelated to speculation⁴² or providing exposure to the commodity markets. Uses of these instruments include, for example, hedging positions, equitizing cash that cannot be immediately invested in direct equity holdings (such as if the stock market has already closed for the day), managing cash positions more generally, adjusting portfolio duration (*e.g.*, seeking to maintain a stated duration of seven years as a fund’s fixed income securities age or mature), managing bond positions in general (*e.g.*, in anticipation of expected changes in monetary policy or the Treasury’s auction schedule), or managing the fund’s portfolio in accordance with the investment objective stated in the fund’s prospectus (*e.g.*, an S&P 500 index fund that tracks the S&P 500 using a “sampling algorithm” that relies in part on S&P 500 or other futures).

⁴² We use the term “speculation” to be consistent with the commodity industry’s common understanding of the term. Registered investment companies, however, do not consider their investment strategies to be “speculative;” the substantive provisions of the Investment Company Act preclude their ability to engage in “speculative” behavior (*see, e.g.*, Section 18 of the Investment Company Act).

Swaps are a particularly useful portfolio management tool because they offer registered investment companies considerable flexibility in structuring their investment portfolios. We offer two examples to illustrate how a registered investment company might use swaps:

- Total return swaps provide an efficient means to gain exposure (*e.g.*, to particular indices, to foreign markets for which there is no appropriate or liquid futures contract, to foreign markets where local settlement of securities transactions may be difficult and costly). A registered investment company might use a total return swap based on a broad market index in order to gain market exposure on cash flows to the investment company until such cash flow is fully invested. It is important that registered investment companies be able to put cash flows “to work” immediately, for the benefit of their shareholders.
- Interest rate swaps are commonly used by registered investment companies that follow fixed income strategies. This type of swap allows the investment company to adjust the interest rate and yield curve exposures of the investment company or to replicate a broadly diversified fixed income strategy (which may be difficult to do solely through direct purchases of bonds). For example, inflation protected funds are now relatively common. To protect against inflation, these strategies use Treasury inflation-protected securities (“TIPS”) or an efficient substitute. Since the market for TIPS is not especially deep, registered investment companies may find it more efficient to achieve inflation protection through interest rate swaps linked to the return on TIPS.

The Commission has failed to justify its broad inclusion of all non-security based swaps in its proposal, despite the variety of ways investment companies may use these instruments, many of which are far afield of running a futures-only investment product. As previously discussed, a far more nuanced analysis of swaps usage by registered investment companies is necessary before this rule can proceed.

2. ICI Member Data Illustrates the Overly Broad Nature of the Rule 4.5 Proposal

As indicated above, the broad language of the proposed conditions, together with the inclusion of swaps, would significantly expand the scope of the Commission’s Rule 4.5 Proposal to an extent the CFTC may not have contemplated and well beyond the Commission’s stated objective, which is to preclude the offering of “futures-only investment products” without CFTC oversight. The preliminary data outlined below serve to illustrate these points.

Information provided by thirteen ICI member firms, which in total advise 2,111 registered investment companies (including SEC-registered open-end funds, closed-end funds (“CEFs”), and ETFs) whose assets total \$2.9 trillion indicates that these member firms have 1,154 separate funds that use or may use derivatives, of which an estimated 485 funds potentially would be unable to meet the criteria for exclusion under proposed Rule 4.5 for various reasons (see Table 1).

Table 1: Use of Derivatives by Investment Companies Managed by Selected ICI Member Firms¹

Number of fund complexes providing information	13
Total assets of open-end funds, CEFs, and ETFs managed by these complexes (\$ millions)	\$2,899
Number of open-end funds, CEFs, and ETFs managed by these complexes	2,111
<i>of which:</i> ²	
Funds that use or invest in derivatives	1,154
<i>of which:</i>	
Funds that may be unable to rely on proposed Rule 4.5	485
<i>of which, funds that primarily:</i> ¹	
Pursue managed futures strategy	23
Seek exposure to physical commodities or other commodity-related strategies	6
Are broad-based diversified funds	190
Are fixed-income funds or other funds using derivatives to meet investment objectives	160
Use other strategies that could be implicated by proposed Rule 4.5	102

Source: ICI compilation of information provided by thirteen ICI member firms.

¹ Includes registered investment companies that are open-end mutual funds, CEFs, and ETFs. All figures in the table refer exclusively to long-term funds. Funds of funds are included in the number of funds but are excluded from asset totals to avoid double counting total assets in these funds.

² Total does not add to 485 because certain fund complexes felt that categorization was too uncertain in light of current lack of specificity in Proposed Rule 4.5.

As Table 1 illustrates, of the 485 investment companies that may be unable to meet the criteria for exclusion under the Rule 4.5 Proposal for various reasons, only 29 investment companies seek returns primarily based on a managed futures strategy or by providing exposure to physical commodities or other commodity-related strategies. By contrast, 190 investment companies are broad-based diversified funds, such as index funds, asset allocation funds, target date funds, inflation-protected funds, or other funds that have exposure to physical commodities as a non-primary component in a broad-based investment strategy. Another 160 of the 485 investment companies are fixed-income or other funds that use financial futures or swaps to help achieve their investment objectives. The remaining 102 investment companies follow other strategies that could be implicated by the proposed rule.

Our members' estimate of 485 investment companies in these 13 complexes that could potentially be implicated by the proposed rule is based on a fair degree of uncertainty. As noted, the proposed rule at present lacks critical details, such as precisely how swaps will be treated, whether

foreign exchange forwards and foreign exchange swaps will be included, and others. Our member firms have thus made a good-faith effort to interpret how the proposed rule may affect the investment companies they advise. The total number of affected investment companies, however, could be either considerably higher or lower depending on the rule's final provisions. In addition, these estimates are *only* for the thirteen member firms that provided information. There are an additional 248 member complexes that either were not asked to provide information or were unable to provide information given the uncertainty inherent in the Rule 4.5 Proposal, including a few of the very largest complexes. Thus, the estimates in Table 1 should not be taken as an upper bound on the likely number of investment companies that could be affected by the Rule 4.5 Proposal, and likely *understate* the number of entities that could be subject to dual registration and regulation by the SEC and CFTC under the Rule 4.5 Proposal. Nonetheless, the data clearly suggest that the rule, at least as proposed, would likely affect a large number and variety of investment companies, the vast majority of which pursue strategies outside the CFTC's intended reach, as stated in the Release.

3. Suggestions for Narrowing the Scope of the Trading Restrictions in the Rule 4.5 Proposal

The Rule 4.5 Proposal incorporates the trading restrictions from the NFA petition with the addition, as discussed above, of swaps. Specifically, a registered investment company would be required to represent, in its notice of eligibility for the exclusion, that it will use commodity futures, commodity options or swaps solely for "bona fide hedging purposes." It may, however, represent that it will hold certain instruments not for bona fide hedging purposes, generally subject to representations that the aggregate initial margin and premiums required to establish those positions will not exceed five percent of the liquidation value of the fund's portfolio (the "Non-Hedging Restriction"). We are concerned that the Non-Hedging Restriction, especially as it would apply to swaps, futures, and options used for non-speculative purposes, would result in a large number of registered investment companies being unable to rely on amended Rule 4.5 and becoming subject to registration with, and regulation by, all of the SEC, the CFTC and NFA. We thus offer several suggestions for how the CFTC might appropriately narrow the scope of these proposed restrictions.

a) The Non Hedging Restriction Should Not Apply to Swaps, or Its Application Should be Significantly Narrowed

Based on data and other information obtained from many of our member firms, we have concluded that a wholesale inclusion of swaps in the Rule 4.5 Proposal could result in advisers to a large number of registered investment companies being unable to rely on the rule's exclusion, burdening the CFTC and NFA with a large number of additional registrants—entities already subject to comprehensive SEC regulation—at a time when CFTC resources are severely constrained.⁴³ Advisers

⁴³ See, e.g., Gensler Remarks, *supra* note 16.

to these investment companies would become subject to CFTC and NFA regulation, even if the investment company's uses of swaps would not raise the concerns that CPO regulation is designed to address.

The Commission also has not provided any analysis that would establish a basis for a wholesale inclusion of swaps in the Rule 4.5 Proposal, and the Proposal's consequent broad reach. While we acknowledge the CFTC's jurisdiction over swaps as a result of the Dodd-Frank Act, we believe its expanded jurisdiction does not relieve the agency of the obligation to provide a clear rationale as to why *users* of swaps need to be registered and to examine whether particular uses of swaps raise the concerns that the Rule 4.5 Proposal is intended to address. If the Commission does not eliminate or narrow the application of the Rule 4.5 Proposal to swaps, as we suggest below, we are concerned that some registered investment companies may choose to limit their use of swaps in order to avoid this second layer of regulation, with potential adverse effects on liquidity of the swaps markets.⁴⁴

For these reasons, we respectfully urge the Commission to eliminate, or at least narrow significantly, the application of the Non-Hedging Restriction to swaps.⁴⁵ We believe such a result would be consistent with the fact that many registered investment companies use swaps for a variety of purposes in connection with the efficient management of their investment portfolios. Further, the use of swaps for these purposes is unrelated to the Commission's stated objective, which is to preclude the offering of "futures-only investment products" without CFTC oversight.

b) The Commission Should Specifically Reference Risk Management as an Element of "Bona Fide Hedging" in the Context of Rule 4.5

We recommend that the Commission specifically reference, in any amendments to Rule 4.5 that include a "bona fide hedging" test, risk management transactions that would encompass contemporary uses of swaps, futures, and options by investment company advisers, on behalf of their funds, for non-speculative purposes. The CFTC has explicitly recognized that hedging includes the concept of risk management and distinguished it from speculative trading. Specifically, in a 1987 agency interpretation ("1987 Interpretation"), the Commission provided for risk management

⁴⁴ See, e.g., Garrett Letter, *supra* note 11 ("... in none of the relevant notices of proposed rulemakings is there any discussion of the impact on liquidity."); October Letter at n.5 (stating that "should the CFTC decide to move forward with a rulemaking to amend Rule 4.5, we would urge the agency to consider carefully the effect that its proposed changes would have on market liquidity."). The Commission's lack of discussion in the Release regarding the potential effects of the Rule 4.5 Proposal on liquidity contrasts with its focus on this issue in 2003 when it amended the rule to eliminate the trading restrictions, in significant part because of concerns about the effects they could have on market liquidity. See 2003 Adopting Release, *supra* note 7.

⁴⁵ The CFTC could do so, for example, by excluding swaps that provide exposure to the securities markets—markets over which the CFTC has no jurisdiction—or interest rate swaps.

exemptions for commodity exchanges from speculative position limit rules.⁴⁶ In the 1987 Interpretation, the CFTC discussed different non-speculative derivatives trading strategies, many of which are used by investment companies.⁴⁷ More recently, the CFTC has applied the concept of risk management in proposing an exception from the mandatory clearing requirement for swaps subject to conditions including, among others, that the entity be using the swap to hedge or mitigate against commercial risk.⁴⁸

We therefore request that the Commission state specifically that risk management will be considered as part of the bona fide hedging test (or as an additional category) in connection with any amendments to Rule 4.5. This would include transactions or positions taken by a registered investment company in futures contracts, options contracts, or swaps if used for the following purposes:

- As alternatives or temporary substitutes for "cash market" positions;
- To mitigate or offset changes in the value of "cash market" positions owned by the investment company or non-derivative liabilities of the investment company;
- To facilitate the investment company's management of its cash and/or reserves;
- To adjust an investment company's duration; or
- To efficiently adjust a fund's exposure to one or more asset allocation categories.

Such a Commission statement would be consistent with current and prior positions of the CFTC.⁴⁹ Use of futures, options, or swaps in these and other ways that allow investment company advisers to manage the risks in their investment portfolios does not present the higher risks to commodity markets

⁴⁶ See *Risk Management Exemptions From Speculative Position Limits Approved Under Commission Regulation 1.61*, 52 Fed. Reg. 34633 (Sept. 14, 1987) (agency interpretation providing for risk-management exemptions, in addition to current exemptions for hedging, from speculative position limit rules of exchanges); see also Report of the Financial Products Advisory Committee of the Commodity Futures Trading Commission, *The Hedging Definition and the Use of Financial Futures and Options: Problems and Recommendations for Reform* (June 15, 1987) ("Committee Report") (Committee's recommendations included, among others, revising Rule 1.61 and issuing guidelines that permit exchanges to exempt from speculative position limits transactions or positions taken for risk-management purposes, revising Rule 1.3 to include a definition of risk management, and revising Rule 4.5 to provide an exclusion from CPO regulation for otherwise-regulated entities that use futures and options for risk-management purposes).

⁴⁷ While the 1987 Interpretation specifically did not address Rule 4.5, it appears that may have been because the Committee Report included separate, specific recommendations related to Rule 4.5 and Rule 1.3(z). See 1987 Interpretation, *supra* note 46 at n.3; Committee Report, *supra* note 46 (recommending revising Rule 1.3(z) to include a definition of risk management and revising Rule 4.5 to provide an exclusion from CPO regulation for otherwise-regulated entities which use futures and options for risk-management purposes).

⁴⁸ See *End-User Exception to Mandatory Clearing of Swaps*, 75 Fed. Reg. 246 (Dec. 23, 2010) (CFTC proposal for elective exception from mandatory clearing requirement for swaps subject to conditions including, among others, that the entity be using the swap to hedge or mitigate against commercial risk) ("Swaps Proposal").

⁴⁹ See, e.g., *id.*; 1987 Interpretation, *supra* note 46; Committee Report, *supra* note 46.

and investors that may be raised by speculation, and should not be subject to the Non-Hedging Restriction.

c) The Threshold for the Non-Hedging Restriction Should be Raised

The threshold for the Non-Hedging Restriction is proposed to be five percent, the same threshold that was included in Rule 4.5 prior to its amendment in 2003. We note, however, that current margin levels for a number of derivative instruments in which registered investment companies invest now exceed five percent of contract value. Almost a decade ago, the CFTC acknowledged that margin levels for certain stock index futures significantly exceeded five percent of contract value and that margin levels for security futures contracts were 20 percent of contract value, which had the effect of limiting their use for non-hedging purposes as compared to instruments subject to lower margin requirements.⁵⁰ These concerns remain valid today, and would be exacerbated by applying the Non-Hedging Restriction to swaps, as contemplated by the Rule 4.5 Proposal.

In the Release, the CFTC requests comment on whether a higher threshold is appropriate. We believe it is, although due to the current high level of uncertainty regarding the regulatory treatment of swaps and the margin levels to which they will be subject, we are unable to recommend what that higher threshold should be. If the threshold for the Non-Hedging Restriction is not raised to reflect the realities of the financial markets in which registered investment companies invest, the result could be that investment companies may alter their investment strategies specifically to avoid exceeding the Non-Hedging Restriction, which would not be in the best interests of investors. We stress that a full analysis of the correct threshold for the Non-Hedging Restriction should be undertaken only after further opportunity for public comment, following resolution of the regulatory issues regarding the status of swaps, foreign exchange swaps, and foreign exchange forwards.

C. Registered Investment Companies Should Continue to be Permitted to Use a Wholly Owned Subsidiary Structure

The Rule 4.5 Proposal would require that any positions in swaps, commodity futures or commodity option contracts for non-hedging purposes would need to be held “by a qualifying entity only.” This language was added by the NFA Petition and was not included in Rule 4.5 as it existed prior to 2003. The language is apparently directed at investment companies’ use of wholly-owned subsidiaries to engage in a limited amount of swaps, commodity futures, and commodity options trading (*i.e.*, no more than 25% of an investment company’s investment portfolio, as disclosed in its registration statement and as specifically permitted by the Internal Revenue Service (“IRS”)) and would effectively preclude a registered investment company from using the subsidiary structure.

⁵⁰ See 2003 Proposing Release, *supra* note 7. These concerns were made moot by the CFTC’s adoption of amendments to Rule 4.5 that eliminated the Non-Hedging Restriction. See 2003 Adopting Release, *supra* note 7.

We emphasize, as we did in the October Letter, that this subsidiary structure is used by registered investment companies for tax purposes and not to evade regulation under the Investment Company Act, which is focused on protecting investors. Under Subchapter M of the Internal Revenue Code of 1986, as amended, each registered investment company is required to realize at least 90 percent of its annual gross income from investment-related sources, which is referred to as “qualifying income.”⁵¹ Direct investments by a registered investment company in commodity-related instruments generally do not, under IRS published rulings, produce qualifying income. As a result, certain registered investment companies sought and received private letter rulings from the IRS that income from a wholly owned subsidiary that invests in commodity and financial futures and options contracts, swaps on commodities or commodity indexes and commodity-linked notes, fixed-income securities serving as collateral for the contracts and potentially cash-settled non-deliverable forward contracts constitutes qualifying income.

If the CFTC has any remaining regulatory concerns about the operations of these subsidiaries, we believe these concerns could be addressed effectively through representations made by the investment company’s adviser that it would make the books and records of the fund’s subsidiary available to the CFTC and NFA staff for inspection upon request and provide transparency about fees, if any, charged by the subsidiary. We strongly recommend that the CFTC make explicit in any reproposal that use of the subsidiary structure as described above would continue to be permitted.

D. Restriction on Marketing

In addition to the Non-Hedging Restriction, the Rule 4.5 Proposal would require that an investment company seeking to rely on the Rule 4.5 exclusion represent that it will not be, and has not been, marketing participations in the fund to the public as or in a commodity pool or otherwise as or in a vehicle for trading in (*or otherwise seeking investment exposure to*) the commodity futures, commodity options, or swaps markets (the “Marketing Restriction”) (emphasis added). The italicized language was not part of the Marketing Restriction in Rule 4.5 prior to 2003 but was introduced in the NFA petition. The CFTC fails to explain why it believes this language is necessary or to give any indication as to its intended scope, despite concerns raised by ICI and other commenters in response to the CFTC’s earlier publication of the NFA’s rulemaking petition. The NFA petition similarly failed to address these issues.

As discussed in our October Letter, ICI and its members are very concerned that this new language could be interpreted broadly, even applying to registered investment companies whose

⁵¹ Income from investment-related sources includes income specifically from dividends, interest, proceeds from securities lending, gains from the sales of stocks, securities and foreign currencies, or from other income (including, but not limited to, gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies, or income from certain types of publicly traded partnerships.

investment portfolios (whether directly or indirectly through a so-called “fund-of-funds” structure) have only a modest exposure to commodity futures, commodity options, and swaps.⁵² The proposed language is also broad enough that it could apply to an investment company’s use of commodity futures, options, or swaps for *bona fide* hedging purposes or within the Non-Hedging Restriction, thereby rendering the trading exceptions within the Rule 4.5 Proposal effectively moot. The language even appears broad enough to capture registered investment companies that invest only in securities and not commodities—entities clearly outside the CFTC’s jurisdiction—such as sector investment companies that invest in securities of oil or mining companies, or other registered investment companies that obtain commodity exposure through investments in securities. Clearly, investments in these securities products cannot result in CFTC registration. Finally, as drafted, the Marketing Restriction could be triggered by basic disclosures in prospectuses and marketing materials concerning the range of investments the investment company may be entitled to make. We outline below several recommendations intended to address these concerns.

1. The Reference to “Otherwise Seeking Investment Exposure” Should Be Deleted

We strongly recommend that the CFTC eliminate from the Marketing Restriction the “otherwise seeking investment exposure” language. We believe that this change would appropriately capture those registered investment companies about which the CFTC may have concerns—funds that are effectively holding themselves out as commodity pools. Adding the investment exposure language only creates ambiguity and would result in a significant number of registered investment companies that do not provide meaningful commodity exposure being unable to satisfy the exclusion and becoming subject to CFTC and NFA regulation, which neither serves the interests of the regulators nor those of investors.

2. Two Tier Registration System

We recommend that advisers to registered investment companies that do not market themselves as commodity pools, according to the revised criteria we suggest above, but hold positions in commodity interests that exceed the threshold under the Non-Hedging Restriction (as we suggest it be amended) be, at most, required to register as CPOs, but not otherwise be subject to the requirements applicable to CPOs under Part 4 of the CFTC’s rules. These investment companies, which may include, among others, fixed-income funds, index funds, inflation-protected funds, asset allocation funds and balanced funds, do not raise the concerns the CFTC seeks to address in its Proposal. Registration of the investment adviser as a CPO would require membership with the NFA, and subject

⁵² Many investment company complexes sponsor funds-of-funds for retail investors. These funds-of-funds are in many cases intended to provide retail investors with broad asset class diversification in a single investment vehicle. As part of that diversification goal, funds-of-funds often invest a portion of their assets in other investment companies whose portfolios may include investments in non-traditional asset classes such as commodities and commodity-related products.

the adviser to examination by the NFA.⁵³ We do not believe it is appropriate to additionally subject the advisers to these registered investment companies, which are already subject to comprehensive regulation under the federal securities laws and rules, to the CFTC's Part 4 requirements, which are designed for CPOs that market their commingled vehicles as commodity pools or provide significant commodity interest exposure.

Because registered investment companies are subject to extensive public disclosure and reporting requirements, the CFTC would have access to comprehensive and detailed information about, among other things, an investment company's risks, holdings, fees, performance information, financial information, and service providers, as well as detailed information about the investment company's adviser, all without applying the CFTC's Part 4 requirements.⁵⁴ Furthermore, the SEC has proposed amendments to Form ADV that would expand even further the information that is required by the form, including disclosure about whether an adviser provides advice with respect to futures contracts, forward contracts, or various types of swaps.⁵⁵ We also note that the CFTC would have antifraud and inspection authority over an adviser that is deemed to be a CPO even without registration. Imposing additional regulatory requirements on the advisers to these registered investment companies would not provide meaningful additional information to investors and, because of the inconsistent and duplicative information requirements of the two regulatory regimes, could instead cause confusion.

3. Need for Clear Guidance

We are aware that others are exploring approaches to the Marketing Restriction that would require registered investment companies to consider a variety of factors, such as how the investment company holds itself out to the public/its representations in materials provided to investors; the composition of the investment company's assets; the activities of its officers and employees; its historical development; and perhaps other factors, to determine whether the investment company's adviser should register as a CPO. If the CFTC determines to adopt this or a similar test, we believe it is absolutely critical that the agency provide clear guidance articulating what the relevant factors are, how they will be weighted, and how the agency expects industry participants to apply them. Certainty will

⁵³ Please see our analysis above, at Section III.A., regarding CPO registration of the investment adviser.

⁵⁴ Please see the examples of fund disclosure and reporting requirements described in Appendix A to this letter. In addition, Part 1A of Form ADV, the registration form for investment advisers, provides detailed information about the investment adviser and its business, including information about the types of clients it has, its advisory services, potential conflicts of interest, custody of client assets, any disciplinary history, its owners and executive officers, and information about certain service providers.

⁵⁵ See *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 3110 (Nov. 19, 2010).

be essential to the usefulness of any such test, both to the industry and to regulators.⁵⁶ It is also critical that the public has an opportunity to comment on any test that the CFTC determines to propose.⁵⁷

4. Other Clarifications

Finally, we respectfully request that the CFTC clarify certain aspects of the Marketing Restriction. We specifically request clarification that the Marketing Restriction would not preclude registered investment companies from including in their registration statements (including prospectuses and statements of additional information), as well as in marketing materials, basic disclosure concerning the range of investments the investment company may be entitled to make as well as risk disclosures that may mention investment in commodity futures, commodity options, and swaps. Our requested clarification is consistent with the CFTC's past interpretations of the marketing restriction.⁵⁸ We further request clarification that the Marketing Restriction would not preclude disclosures concerning the range of investments or risks of a fund of funds relating to its investments in underlying funds which may include limited commodity exposure, when those investments are made as part of an Investment Company Act-registered investment product, such as a target date or asset allocation fund.

IV. Registered Investment Companies Should Not Be Subject to Overlapping and Conflicting Regulatory Requirements

As noted above, investment companies are already extensively regulated under the Investment Company Act and other federal securities laws. The protections afforded under the securities laws include, among others: limits on the use of leverage; antifraud provisions; comprehensive disclosure to investors, including with regard to fees and expenses, the investment objectives and strategies of the investment company, and the risks of investing in the investment company; oversight by an independent board of directors, particularly with regard to potential conflicts of interest; restrictions on transactions with affiliates; and requirements regarding custody of the investment company's assets. As we discuss above, we believe strongly that the Rule 4.5 Proposal is overbroad and would subject registered investment company advisers to CPO regulation in cases where a second layer of regulation is not necessary.

⁵⁶ We also note that, to the extent applicability of the test is unclear, advisers that do not register as CPOs based on a good faith application of the enumerated factors nevertheless could be subject to the hindsight analysis used in some private lawsuits claiming that, in fact, the adviser should have registered.

⁵⁷ See *Kooritzsky*, *supra* note 15, at 1513; *Shell Oil*, *supra* note 15, at 751.

⁵⁸ The CFTC has previously stated that it will allow, within the Marketing Restriction, "any promotional material required by and consistent with the policies of a qualifying entity's other Federal or State regulator," as well as permit "a [registered investment company] to describe accurately in its sales literature the limited use of its commodity interest trading and how it believes that use will be beneficial." See 1985 Adopting Release, *supra* note 30, at C.3.

Even if the trading and marketing restrictions in the Rule 4.5 Proposal are appropriately scaled back, there are likely to be cases in which advisers to registered investment companies would be unable to rely on the amended rule and may have to comply with Part 4 of the CFTC's rules. For this reason, we believe it is critical that the CFTC work closely with the SEC *before* amending Rule 4.5 in order to reconcile the many conflicting and duplicative CFTC and SEC regulations to which these investment companies and their advisers would be subject. The harmonized regulations then should be repropose for public comment.

A. Reconciliation of Duplicative or Conflicting Regulatory Requirements

Registered investment companies are subject to extensive disclosure and reporting requirements. Many of these are very similar to the requirements to which CPOs are subject, including the requirement to deliver disclosure documents to shareholders/participants in connection with offers and sales to investors, and requirements to provide periodic reports to shareholders/ participants, as well as reports to regulators. We believe that, in those areas where SEC and CFTC requirements are similar, requiring registered investment companies to comply with both sets of regulatory requirements would be burdensome and costly, as well as potentially confusing to investors; these largely duplicative requirements also would not provide meaningful improvement in the regulatory protections provided. Therefore, we recommend that, as to those matters, the relevant SEC provisions should apply. It is more efficient for registered investment companies to comply with provisions to which they are currently subject, and to which the other registered investment companies in their complexes would be subject. Those provisions, based on the similarities to the CFTC's requirements, would appear to satisfy the CFTC's regulatory interest.

In other areas, the requirements under the Investment Company Act and the Commodity Exchange Act are wholly inconsistent and would require reconciliation or further guidance from the SEC and CFTC before an adviser to a registered investment company could comply. While the Commission requests comment in the Release regarding "how these [conflicts] could be addressed by the two Commissions,"⁵⁹ it provides no guidance on how that might be accomplished. In order to meet the notice and comment requirements of the APA, we strongly believe the agency must repropose the rule to include a detailed proposal for how conflicting or inconsistent requirements will be reconciled, or detailed discussion regarding the guidance it proposes to provide.⁶⁰

We have compared the SEC and CFTC requirements that would be applicable to CPOs of registered investment companies subject to Part 4 of the CFTC's regulations in Appendix A to this letter. In addition, we discuss below several areas in which we specifically request relief from the CFTC.

⁵⁹ See Release, *supra* note 2, at 7984.

⁶⁰ See *Kooritzsky*, *supra* note 15; *Shell Oil*, *supra* note 15.

B. *Areas in Which CFTC Relief is Necessary*

1. Disclosure document delivery and acknowledgment

The disclosure document delivery and acknowledgment requirements applicable to commodity pools differ from the prospectus delivery requirements applicable to registered investment companies. Specifically, Rule 4.21(a) under the Commodity Exchange Act requires that a CPO deliver a disclosure document to a prospective pool participant “by no later than the time it delivers to the prospective participant a subscription agreement for the pool,” and Rule 4.21(b) states that the CPO may not accept money from a prospective pool participant unless the CPO first receives from the prospective participant a signed and dated acknowledgement stating that the participant received the disclosure document describing the pool that is required under the Commodity Exchange Act (the “Disclosure Document”).⁶¹ Registered investment companies are required to deliver a prospectus to prospective investors no later than when a transaction confirmation is delivered.⁶² Delivery or use of a subscription agreement is not required for a registered investment company, nor is receipt of a signed and dated acknowledgement.

The CFTC has recognized that the prospectus delivery requirements under the federal securities laws differ from CFTC regulations “with respect to timing and other aspects.”⁶³ The CFTC has proposed, and its staff has granted, relief from the disclosure document delivery and acknowledgement requirement of Rule 4.21 for commodity exchange traded funds (“commodity ETFs”). As the CFTC has acknowledged for CPOs of commodity ETFs, “simultaneous compliance with both sets of requirements [is] unnecessarily cumbersome, and would needlessly interfere with the established procedures for conducting a registered public offering of shares . . .”⁶⁴ The same would be true for registered investment companies and their advisers. The compliance difficulties are equally challenging regardless of whether a pool is listing its shares on an exchange or otherwise offering them publicly. We therefore request relief, on behalf of our members that could be subject to the Part 4 regulations, from the Disclosure Document delivery requirement of Rule 4.21(a) and from the signed acknowledgement requirement of Rule 4.21(b) similar to that which the CFTC recently proposed for commodity ETFs.⁶⁵ In addition, we request relief from the requirements in Rule 4.26(d)(1) and (2)

⁶¹ See Rules 4.21 and 4.24 under the Commodity Exchange Act.

⁶² See Section 5 of the Securities Act of 1933 (“1933 Act”) and Rule 10b-10 under the Securities Exchange Act of 1934.

⁶³ See Commodity ETF Release, *supra* note 34.

⁶⁴ *Id.* at 54795.

⁶⁵ Because we are requesting relief based on conditions that the CFTC has proposed but not yet adopted, we request the opportunity here and below to revisit the conditions to the relief if the CFTC subsequently adopts different conditions for commodity ETFs.

under the Commodity Exchange Act, which require a CPO to file the Disclosure Document and amendments with the NFA prior to use. In particular, the registered investment company's CPO would satisfy conditions analogous to those proposed for CPOs of commodity ETFs, including:⁶⁶

- Causing the investment company's prospectus and statement of information ("SAI") to be readily accessible on an Internet website maintained by the adviser;
- Causing the investment company's prospectus and SAI to be kept current;⁶⁷
- Informing prospective investment company investors of the Internet address of the website and directing any broker, dealer or other selling agent to whom the investment company's principal underwriter sells shares of the investment company to so inform prospective investors;
- Complying with all other requirements applicable to pool Disclosure Documents under Part 4 of the CFTC's regulations except (1) those with which the investment company should be deemed to already satisfy (as described in Appendix A), and (2) those with which the investment company would be unable to comply (absent the CFTC's reconciliation of conflicting CFTC and SEC regulations or obtaining relief as requested in this letter).

2. Updating of Prospectus and SAI

CPOs are required by the rules under the Commodity Exchange Act to update a commodity pool's Disclosure Document every nine months.⁶⁸ Registered investment companies, however, are permitted under the federal securities laws to update their registration statements (including their prospectuses and SAIs) annually.⁶⁹ Requiring registered investment companies to update their prospectuses every nine months would increase costs for registered investment companies whose advisers do not qualify for exclusion under Rule 4.5. Because the registered investment company's audited financial statements would not be completed when the nine month update was due, the fund would be required to file supplemental/post-effective amendments with the SEC to add the audited financial statements. Such a requirement would also place those investment companies managed by an adviser subject to Part 4 of the CFTC regulations on a different updating cycle than other investment companies managed by the adviser, which would be costly and inefficient. We therefore request that

⁶⁶ Proposed Rule 4.12(c)(2)(i)(A)-(D). Commodity ETF Release, *supra* note 34, at 54800.

⁶⁷ We would cause the investment company's prospectus and SAI to be kept current in accordance with the requirements of the federal securities laws, rather than the rules under the Commodity Exchange Act. Please see our request for relief below.

⁶⁸ Rule 4.26(a)(2) under the Commodity Exchange Act provides that "[n]o commodity pool operator may use a Disclosure Document . . . dated more than nine months prior to the date of its use."

⁶⁹ Section 10(a)(3) of the 1933 Act states that "when a Prospectus is used more than nine months after the effective date of its registration statement, the information contained therein shall be as of a date not more than sixteen months prior to such use...."

investment companies be permitted to satisfy the federal securities law standard for updating, rather than being required to update every nine months.⁷⁰ We do not believe that requiring that prospectuses be updated more frequently would materially increase protections for investors, but would increase costs to them.

3. Shareholder/Participant Reporting Requirements

The rules under the Commodity Exchange Act and the Investment Company Act impose similar obligations as regards periodic reports to be delivered to participants and shareholders, respectively. Both the SEC and the CFTC require the delivery of annual reports to shareholders containing audited financial statements.⁷¹ The SEC also requires the delivery of semi-annual reports to shareholders containing unaudited financial statements.⁷² The CFTC, however, requires that CPOs of pools with net assets of more than \$500,000 at the beginning of the pool's fiscal year deliver to pool participants a *monthly* Account Statement that includes an unaudited Statement of Operations and a Statement of Net Assets.⁷³ Complying with the monthly reporting requirement would be unduly burdensome and costly for the CPO to a registered investment company because registered investment companies are not currently required to create monthly reports, most registered investment companies redeem their shares on a daily basis, and shares are often held in book-entry form.⁷⁴

Accordingly, we request that investment companies that satisfy the periodic reporting requirements under the Investment Company Act be granted relief from the monthly Account Statement requirements under the Commodity Exchange Act.⁷⁵ Requiring registered investment companies to create monthly reports only for those funds that would be subject to Part 4 of the CFTC's regulations would be very costly and burdensome. We believe that the semi-annual reporting requirements under the Investment Company Act provide comparable protections to investment company shareholders. We further note that rules under the Investment Company Act require a registered investment company to file a quarterly report 60 days after the close of the first and third

⁷⁰ See Appendix A. In addition, we request relief, above, from the requirement in Rule 4.26(d)(2) under the Commodity Exchange Act to file amendments to the Disclosure Document with the NFA.

⁷¹ See Rule 30e-1 under the Investment Company Act and Rule 4.21(c) under the Commodity Exchange Act.

⁷² See Rule 30e-1 under the Investment Company Act.

⁷³ See Rule 4.22(a) under the Commodity Exchange Act. Also see Appendix A for a detailed comparison of the reporting requirements.

⁷⁴ Most registered investment companies would meet the rule's \$500,000 threshold.

⁷⁵ We note that the CFTC has proposed, and its staff has granted, relief from the Account Statement delivery requirement for commodity ETFs. See Commodity ETF Release, *supra* note 34.

quarters that contains a schedule of investments and other disclosures.⁷⁶ This report is publicly available to investors.

We agree that the relief would be subject to conditions analogous to those proposed for CPOs of commodity ETFs, including:⁷⁷

- Keeping the annual and semi-annual reports sent to shareholders readily accessible on the adviser's website for a period of 30 days following the date they are first posted on the website;
- Indicating in the investment company's prospectus or SAI that the company's annual and semi-annual reports will be readily accessible on the adviser's website; and
- Including in the prospectus or SAI the Internet address where the investment company's annual and semi-annual reports are available.

4. Books and Records

CFTC rules require that a CPO maintain required pool books and records at its main business address.⁷⁸ Rules under the Investment Company Act, by contrast, generally require that the books and records of a registered investment company be preserved for specified periods of time, with more recent books and records typically preserved in an "easily accessible place."⁷⁹ These rules also permit a registered investment company to have a third party maintain the books and records on its behalf, if the investment company and the third party enter into a written agreement specifying that the records are the property of the registered investment company and stating that such records will be surrendered promptly on request.⁸⁰ An investment adviser is also required to specify on its Form ADV each entity that maintains its books and records, including the location of the entity, and a description of the books and records maintained at that location.⁸¹ It would be burdensome and inefficient for CPOs to registered investment companies to develop different procedures and systems to maintain solely those books and records relating to their commodity trading.

We therefore request relief from Rule 4.23 on behalf of our members to permit a registered investment company's CPO to maintain the CPO's books and records required by the Commodity

⁷⁶ See Rule 30b1-5 under the Investment Company Act.

⁷⁸ See Rule 4.23 under the Commodity Exchange Act.

⁷⁸ See Rule 4.23 under the Commodity Exchange Act.

⁷⁹ See Rule 31a-2 under the Investment Company Act.

⁸⁰ See Rule 31a-3 under the Investment Company Act.

⁸¹ See Item 1(K) of Form ADV and Section 1.K. of Schedule D of Form ADV.

Exchange Act with professional service providers as permitted by the Investment Company Act. We note that the CFTC has proposed, and its staff has granted, similar exemptive relief permitting CPOs to commodity ETFs to keep books and records with certain professional service providers, rather than at the CPO's main business address.⁸² We believe compliance with the SEC books and records requirements would be fully consistent with investor protection, and would provide the CFTC with any information it may want about entities that maintain an investment adviser CPO's books and records, as those entities will be identified (and the books and records they maintain described) on the adviser's Form ADV.

5. Adviser CPOs Should Be Able to Provide SEC-Required Risk Disclosures to Satisfy the CFTC's Proposed Swap Risk Disclosure Requirement

In the Release, the CFTC also proposes to amend the mandatory risk disclosure statements under the Commodity Exchange Act for CPOs and CTAs to require disclosure about certain risks specific to swaps transactions.⁸³ While we fully support strong risk disclosure to investors, we also believe such disclosure must be accurate in order to be effective.

We are concerned that the CFTC's proposed language fails to capture the variety of ways in which registered investment company advisers that are CPOs and CTAs may use swaps, which we describe above, and that, as a result, the disclosure may provide investors with a misleading impression of the risks presented by an investment company's use of such instruments. We therefore recommend, in lieu of the proposed language, that if an adviser is a CPO or CTA to a registered investment company that engages in swaps transactions, the CFTC's proposed risk disclosure requirement would be satisfied by the risk disclosures that the SEC currently requires of registered investment companies, which are comparable and allow an investment company to tailor its disclosure to convey the particular risks presented by its use of swaps.⁸⁴

Alternatively, we recommend that the CFTC require an adviser that is a CPO or CTA to such a registered investment company to omit the second paragraph of the proposed risk disclosure language. The second paragraph provides that:

⁸² See Commodity ETF Release, *supra* note 34, at 54796. We note that professional services providers commonly used by registered investment companies are not limited to those the CFTC has included in its proposed exemptive relief (*i.e.*, the pool's administrator, its distributor, or a bank or registered broker or dealer that is providing services to the CPO or the pool similar to those provided by an administrator or distributor), and may also include professional records maintenance and storage companies.

⁸³ See Rules 4.24(b) and 4.34(b) under the Commodity Exchange Act.

⁸⁴ See Items 4 and 9 of Form N-1A under the Investment Company Act, which require a registered investment company to disclose the principal risks associated with investing in the company, as well as Item 16 of the SAI, which requires additional information about the risks of investing in the company.

Highly customized swaps transactions in particular may increase liquidity risk, which may result in a suspension of redemptions. Highly leveraged transactions may experience substantial gains or losses in value as a result of relatively small changes in the value or level of an underlying or related market factor.⁸⁵

This disclosure is inapposite to registered investment companies. First, most registered investment companies issue redeemable securities and are not permitted, under the Investment Company Act, to suspend redemptions without obtaining an SEC order.⁸⁶ Second, the Investment Company Act does not permit registered investment companies to engage in “highly leveraged transactions,” as investment companies are subject to strict capital and asset coverage requirements.⁸⁷ Requiring registered investment companies to make the disclosures quoted above would be tantamount to requiring them to make materially misleading statements.

C. Request For Clarification Regarding Series Investment Companies

We request clarification from the CFTC regarding the treatment of series investment companies. For reasons of efficiency, a registered investment company is frequently organized as a single corporation or statutory trust that has multiple “series,” each of which represents an interest in a separate pool of securities with separate assets, liabilities, and shareholders. While the corporation or trust is the entity that registers with the SEC, the registrant is required to amend its registration statement each time it creates a new investment company by issuing a new series. It is common practice for registered investment companies to use the series form, and there are mutual fund families that have single registered investment companies with over 100 series. The courts have treated series investment companies as separate corporate entities for purposes of inter-series liability.⁸⁸

⁸⁵ See Release at 7990-91.

⁸⁶ See Section 22(e) of the Investment Company Act and Rule 22c-1 under the Act. On rare occasions, the SEC has granted relief, either under Section 22(e) or Rule 22c-1, to investment companies experiencing “emergency situations” that make it difficult to calculate their net asset values in order to meet purchase or redemption requests. Snowstorms, power outages, and similar events fall into this category.

⁸⁷ See Section 18 of the Investment Company Act.

⁸⁸ See *Seidl v. American Century Companies, Inc.*, 713 F.Supp.2d 249, 257 (S.D.N.Y. 2010) (stating that “[t]he individual series of a registered investment company are, for all practical purposes, treated as separate investment companies . . . and therefore any recovery in a derivative suit would go to the shareholders of the [affected fund], not to the shareholders of [the investment company’s] other funds”); and *In re Mutual Funds Inv. Litig.*, 519 F.Supp.2d 580, 588-89 (D.Md. 2007) (stating that the practice of establishing individual series of a registered investment company “is entirely in accord with applicable rules of the SEC, which has expressly pronounced that under such circumstances each series is to be treated as a separate investment company”); see also *Stegall v. Ladner*, 394 F.Supp.2d 358, 362-363 (D.Mass. 2005).

The CFTC, both historically and recently, has recognized pools organized in series form as separate investment pools. The CFTC explicitly recognizes series companies in its rules, and acknowledges that each series should be treated as a separate pool if it has limited liability.⁸⁹ In addition, when the CFTC adopted the Rule 4.5 exclusion, it specifically stated that it would treat each separate series of an investment company separately for purposes of determining whether the series satisfied the criteria for exclusion from the rule. In doing so, it noted approvingly its staff's statement from an interpretive letter that:

... in light of the separate ownership in and identities of the Fund's Portfolios -- *e.g.*, separate investment objectives, net asset valuation and dividend policies -- we believe it consistent with the intent of proposed Rule 4.5 to treat as separate entities each of the two Portfolios that intend to engage in commodity interest trading for purposes of determining whether the criteria of the proposal have been met. Conversely, where such separate ownership and identities are not present, we might find it more consistent with proposed Rule 4.5 to aggregate all of the portfolios of a series investment fund in determining whether the criteria have been met.⁹⁰

More recently, the CFTC has recognized series companies in its final rules for periodic account statements and annual financial reports, taking the position that series with limits on inter-series liability should be treated as separate pools for account statement disclosure purposes.⁹¹

We are aware, however, that the CFTC staff has recently taken the position that CPOs seeking to register new funds that are organized in series form may not use standalone prospectuses for each separate series but must instead include all the series in a trust in a single prospectus. We believe such a result is inconsistent with treatment of series investment companies both by the SEC, as discussed above, as well as the CFTC's own rules and prior positions, and request that the CFTC clarify that series investment companies should be treated the same as investment companies that are not organized in series form. This clarification would be fully consistent with CFTC positions, SEC treatment of series investment companies, and the decisions of courts that have considered the issue.⁹²

⁸⁹ See Rule 4.7(b)(2)(iv) and 4.7(b)(3)(i)(D) under the Commodity Exchange Act (exemption for CPOs that offer or sell commodity pool participations only to qualified eligible persons includes periodic reporting relief and annual report relief that provides that, in the case of a pool that is a series fund with limited liability, the account statement or financial statements required are not required to include consolidated information for all series of the pool).

⁹⁰ 1985 Adopting Release, *supra* note 30.

⁹¹ See *Commodity Pool Operator Periodic Account Statements and Annual Financial Reports*, 74 Fed.Reg. 75785, 75786 (Nov. 9, 2009).

⁹² See *id.*; 1985 Adopting Release, *supra*, note 30; *Seidl*, *supra* note 88.

V. Request for Adequate Transition Period and Grandfathering

If the CFTC nonetheless determines to proceed with amendments to Rule 4.5, we believe that, once any such amendments are adopted, it will be critical for investment advisers and investment companies to have adequate time to make the changes to their operations and policies and procedures necessary to comply with the amended rule. Given the many uncertainties about the rule at this time and the many changes that could be required if it is adopted, especially if rules of the SEC and CFTC are reconciled, we believe it will be essential for the Commission to provide a substantial transition period for compliance with any amended rule, although it is difficult at this time to estimate what that period should be. The length of such a transition period should be a specific request for comment in any reproposal. As a matter of fairness, we also request that those registered investment companies that have previously claimed reliance upon current Rule 4.5 be exempted from compliance with any amendments to the rule, as these funds are structured to rely on the exclusion in its current form.

* * * * *

As outlined above, we believe the Rule 4.5 Proposal is deeply flawed and requires significant additional modification before adoption is appropriate. We thus respectfully request that the CFTC fully and carefully consider all of the concerns raised in our letter and by other commenters and, if it continues to believe that amendments to Rule 4.5 are necessary, to repropose those amendments, taking into consideration the views of commenters.

ICI and its members stand ready to assist the Commission in this important and challenging effort. If you have questions or require further information, please contact me at 202/326-5815, Sarah A. Bessin at 202/326-5835, or Rachel H. Graham at 202/326-5819.

Sincerely,

/s/

Karrie McMillan
General Counsel

cc: The Honorable Gary Gensler, Chairman
The Honorable Michael V. Dunn, Commissioner
The Honorable Jill E. Sommers, Commissioner
The Honorable Bart Chilton, Commissioner
The Honorable Scott D. O'Malia, Commissioner

Mr. David Stawick

April 12, 2011

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Kevin P. Walek, Assistant Director
Amanda Leshner Olear, Special Counsel
Daniel S. Konar II, Attorney-Adviser
Division of Clearing and Intermediary Oversight

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

Eileen Rominger, Director
Division of Investment Management, SEC

Comparison of Requirements Applicable to Registered Investment Companies and Commodity Pool Operators

Disclosure Requirements:

SEC Requirement	CFTC Requirement	Recommended Result
<p>Disclosure Document – Form N-1A sets forth the disclosure that a registered investment company must include in its registration statement and is divided into three parts – the Prospectus, the SAI and the Wrapper/Part C. While the Prospectus is generally the only document that a registered investment company must deliver to prospective investors, the SAI, which includes additional information describing the registered investment company, is available to investors upon request at no charge. These documents are subject to SEC pre-effective review.</p>	<p>Rules 4.21 and 4.24 together require a CPO to provide a single Disclosure Document to prospective participants that includes certain information describing the pool.</p>	<p>Registered investment companies should be deemed to have met CFTC requirements if they satisfy SEC requirements and pre-clearance by the NFA should not be required.</p>
<p>Investment Program – Items 2, 4 and 9 of Form N-1A require a registered investment company to state its investment objective and to disclose the principal investment strategies that will be used to seek to accomplish that objective. The SAI requires additional information about the investment company's investment program.</p>	<p>Rule 4.24(h)(1) and (2) require a CPO to provide a description of “the trading and investment programs and policies that will be followed by the offered pool...” and “the types of commodity interests and other invests which the pool will trade...”</p>	<p>Registered investment companies should be deemed to have met CFTC requirements if they satisfy SEC requirements.</p>
<p>Principal Risks – Items 4 and 9 of Form N-1A require a registered investment company to disclose the principal risks</p>	<p>Rule 4.24(g) requires a CPO to disclose “the principal risk factors of participation in the offered pool.”</p>	<p>Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement.</p>

SEC Requirement	CFTC Requirement	Recommended Result
<p>associated with investing in the registered investment company. The SAI requires additional information about the risks of investing in the investment company.</p>		
<p>Fee Disclosure - Item 3 of Form N-1A requires a registered investment company to include in its Prospectus a fee table and expense example disclosing its fees and expenses. The fee table generally discloses shareholder fees (maximum sales charge imposed on purchases, maximum deferred sales charge, maximum sales charge imposed on reinvested dividends, redemption fee, exchange fee and maximum account fee) and annual operating fund expenses (management fees, distribution and/or service fees, other expenses) on a percentage basis. Items 10 and 12 require additional disclosure regarding management fees and sales expenses. Detailed narrative and historical expense disclosure is required in the SAI, including total dollar amounts of advisory fees for each of the last three fiscal years, fees paid to other service providers for management-related services for each of the last three years, distribution-related fees paid during the last fiscal year and the purposes for which such payments were made, aggregate brokerage commissions for each of the last three fiscal years,</p>	<p>Rule 4.24(i) requires a CPO to include in the Disclosure Document for its pool “a complete description of each fee, commission and other expense which the commodity pool operator knows or should know has been incurred by the pool for its preceding fiscal year and is expected to be incurred by the pool in its current fiscal year, including fees or other expenses incurred in connection with the pool’s participation in investee pools and funds.” The rule includes a non-exhaustive list of fees that must be described in the Disclosure Document, including management fees, brokerage fees and commissions, fees paid in connection with trading advice provided to the pool, incentive fees, commissions that may accrue in connection with the solicitation of participants in the pool, professional and general administrative fees and expenses, organizational and offering expenses, clearance fees and any other direct or indirect cost. The disclosure must also include a break-even analysis that reflects all fees, commissions and other expenses of the pool.</p>	<p>These requirements are in many respects duplicative and, in others, inconsistent. The formats for disclosing fees are different. Requiring registered investment companies to comply with both sets of requirements would be redundant and confusing to shareholders. We therefore believe registered investment companies should be deemed to have met CFTC requirements if they satisfy SEC requirements.</p>

SEC Requirement	CFTC Requirement	Recommended Result
<p>brokerage commissions paid to affiliates for each of the last three fiscal years, compensation paid to the investment company's principal underwriter and director/trustee compensation. Item 27(d)(1) of Form N-1A also requires an example of the effect of expenses on a shareholder account, and must appear in every annual and semi-annual shareholder report.</p>		
<p>Performance Disclosure – Item 4 of Form N-1A generally requires a registered investment company to include a bar chart showing the investment company's annual total returns for each of the last 10 calendar years, but only for periods subsequent to the effective date of the registration statement. Following the chart, the investment company must disclose the highest and lowest quarterly return during the 10 years covered by the chart (or since inception if less than 10 years). Form N-1A also requires an investment company to disclose its average annual total returns for the last 1, 5 and 10 years (or since inception if less than 10 years) and to compare its returns to a broad-based securities market index. An investment company is permitted to include in its registration statement performance data for other accounts only in circumstances where the other account is</p>	<p>Rule 4.24(n) requires a pool to include past performance of the pool and in some cases of the CPO's other pools, as set forth in Rule 4.25, which requires a significant amount of performance data that is different from that required or permitted under Form N-1A. In addition to performance data for the pool, the CPO must disclose information for the performance of each other pool it operates (and by the trading manager if the offered pool has a trading manager) if the applicable pool has less than three years of actual performance. Further, if the CPO (or the trading manager) has not operated for at least three years any pool in which 75% or more of the contributions to the pool were made by persons unaffiliated with the pool operator, the trading manager, the pool's CTAs or their respective principals, the CPO also must disclose the performance of each</p>	<p>These requirements directly conflict and will need to be reconciled. Registered investment companies should be permitted to show only the information required by Form N-1A and related SEC and SEC staff interpretations, including with respect to performance of other pools and accounts. A registered investment company is permitted to include in its registration statement performance data for other accounts only in circumstances where the other account is managed in a substantially similar manner, among other requirements. In addition, FINRA rules generally prohibit broker-dealers from using sales literature for a registered investment company that includes the performance of other accounts. This approach is different than that taken under Rule 4.25, which in certain cases requires performance of all pools (including privately offered</p>

SEC Requirement	CFTC Requirement	Recommended Result
managed in a substantially similar manner, among other requirements.	pool operated by and account traded by the trading principals of the CPO. The performance of any accounts (including pools) directed by a major commodity trading adviser must also be disclosed. The CPO also must disclose the performance of any major investee pool.	pools) and accounts of the CPO or CTA, whether or not they are managed in a substantially similar manner. Moreover, the inclusion of performance information for a private fund in a prospectus for a publicly offered registered investment company, as may be required under the CFTC’s performance disclosure requirements, could jeopardize the ability of the private fund to rely on the private offering exemption from registration that is provided pursuant to Regulation D under the 1933 Act.
Management – Items 5 and 10 require a registered investment company to disclose the name and experience of each investment adviser and portfolio manager for the investment company. The SAI requires additional disclosure about investment advisers and portfolio managers.	Paragraphs (e) and (f) of Rule 4.24 require the Disclosure Document to include, among other things, the name and business background of each CPO, the pool’s trading manager, and each major commodity trading adviser.	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement.

Disclosure Document Delivery and Updating Requirements

SEC Requirement	CFTC Requirement	Recommended Result
Disclosure Document Delivery Section 5 under the 1933 Act, the primary provision governing the receipt and timing of Prospectus delivery, does not necessarily require delivery of a Prospectus prior to investment and also does not require delivery or use of a subscription agreement. Rule 10b-10 requires broker-dealers to deliver	Rule 4.21(a)(1) provides that “each commodity pool operator...must deliver or cause to be delivered to a prospective participant in a pool that it operates or intends to operate a Disclosure Document for the pool prepared in accordance with [Rule] 4.24 <u>by no later than the time it delivers to the prospective participant a</u>	We request that the CFTC grant exemptive relief to adviser CPOs subject to Part 4 (similar to the relief that has been granted to CPOs of commodity ETFs) to permit advisers to make available fund prospectuses and SAIs on their websites. We believe that filing with, and pre-clearance by, the NFA should not be required.

SEC Requirement	CFTC Requirement	Recommended Result
confirmations of securities transactions, and the Prospectus delivery requirements would ensure that a Prospectus is delivered no later than with the transaction confirmation.	<u>subscription agreement for the pool.</u> ” (Emphasis added.) The Disclosure Document also must be filed with and pre-cleared by the NFA under Rule 426(d)(1).	
Disclosure Document Updating- Section 10(a) of the 1933 Act effectively permits an investment company to update its registration statement annually. In particular, Section 10(a)(3) states that “when a Prospectus is used more than nine months after the effective date of its registration statement, the information contained therein shall be as of a date not more than sixteen months prior to such use...”	Rule 4.26(a)(2) provides that “[n]o commodity pool operator may use a Disclosure Document...dated more than nine months prior to the date of its use.” The updated Disclosure Document also must be filed with and pre-cleared by the NFA under Rule 426(d)(2).	We request exemptive relief so that registered investment companies may update based on the SEC requirements. We believe that filing with, and pre-clearance by, the NFA should not be required.
Registered investment companies must supplement their Prospectuses and SAIs to correct material inaccuracies and omissions, but, to the extent supplements are mailed to existing shareholders, the mailings typically are timed to coincide with other regular mailings to manage costs. Some changes are so material that the investment company may mail supplements to shareholders immediately. In certain cases, an investment company may not deliver supplements to existing shareholders absent an additional investment.	Rule 4.26(c)(1) requires a CPO to update its Disclosure Document to correct any material inaccuracies or omissions, and to deliver the updated information to existing pool participants within 21 calendar days of the date upon which the CPO first knows or has reason to know of the defect.	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement.
Disclosure Document Acknowledgment - There is no requirement under the federal securities laws that investment	Rule 4.21(b) provides that “[t]he commodity pool operator may not accept or receive funds, securities or other property from	We request that the CFTC grant exemptive relief to adviser CPOs similar to the relief that has been granted to CPOs of

SEC Requirement	CFTC Requirement	Recommended Result
company investors acknowledge receipt of a Prospectus.	a prospective participant <u>unless the pool operator first receives from the prospective participant an acknowledgement</u> signed and dated by the prospective participant stating that the prospective participant received a Disclosure Document for the pool.” (Emphasis added.)	commodity ETFs. Requiring an acknowledgment is fundamentally inconsistent with the registered investment company distribution model.
Additional Documents -- The federal securities laws do not require an investment company to distribute its shareholder reports with the investment company Prospectus, but require registered investment companies to disclose in the Prospectus how shareholders can obtain such documents at no charge.	Rule 4.26(b) generally requires a CPO to attach to its Disclosure Document the applicable pool’s most current Account Statement (discussed below) and Annual Report.	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirements.

Participant/Shareholder Reporting Requirements:

SEC Requirement	CFTC Requirement	Recommended Result
Rule 30e-1 under the Investment Company Act requires a registered investment company to send to its shareholders at least semi-annually a report containing financial statements and other required disclosures. The annual report must contain audited financial statements. Rule 30b2-1 requires that the reports to shareholders, along with certain additional information, be filed with the SEC on Form N-CSR.	Rule 4.21(c) requires each CPO to “distribute an Annual Report to each participant in each pool that it operates....” The Annual Report must include, among other things, audited financial statements.	We request that the CFTC grant exemptive relief to adviser CPOs (similar to the relief that has been granted to CPOs of commodity ETFs) to permit advisers to make available annual and semi-annual shareholder reports required by Rule 30e-1 on their websites.
While the federal securities laws do not require a registered investment company to	Rule 4.22(a) generally requires “each commodity pool operator...[to] distribute to each	We request that the CFTC grant exemptive relief to adviser CPOs (similar to the relief that

SEC Requirement	CFTC Requirement	Recommended Result
distribute a monthly report or account statement to shareholders, they require certain interim reports in addition to the annual report noted above. For example, Rule 30e-1 and Rule 30b2-1 cited above require filing and delivery to shareholders of a semi-annual report, in addition to the filing and delivery of the annual report. In addition, Rule 30b1-5 under the Investment Company Act requires a registered investment company to file a quarterly report on Form N-Q within 60 days after the close of the first and third quarters containing a schedule of investments and other disclosures.	participant in each pool that it operates, within 30 calendar days after the last date of the reporting period...an Account Statement, which shall be presented in the form of a Statement of Operations and a Statement of Changes in Net Assets, for the prescribed period.” Rule 4.22(b) states that the Account Statement must be distributed at least monthly in the case of pools with net assets of more than \$500,000 at the beginning of the pool’s fiscal year, and otherwise at least quarterly.	has been granted to CPOs of commodity ETFs) to permit advisers to make available annual and semi-annual shareholder reports required by Rule 30e-1 on their websites.

Regulatory Reporting Requirements:

SEC Requirement	CFTC Requirement	Recommended Result
Form N-SAR – Items 1-6 require information regarding the name of the investment company, its SEC file numbers and address, among other things. Item 75 requires information regarding assets under management.	Form CPO-PQR Schedule A, Part 1 – Part 1 requests information that is comparable to that requested in Form N-SAR, Items 1-6 and 75. Part 1 requires CPOs to report basic identifying information about the CPO, including its name, NFA identification number and assets under management.	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement.
Form N-SAR requires the name of each series of the registrant (Item 7); the identification of key service providers (Items 8-15); information regarding portfolio investments and	Form CPO-PQR Schedule A, Part 2 – Part 2 would require a CPO to report information regarding each of its commodity pools, including the names and NFA identification numbers,	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement. While there are some differences between the requirements of

SEC Requirement	CFTC Requirement	Recommended Result
<p>positions (Items 67-70); and information regarding subscription and redemption activity (Item 28). Performance information is not specifically required by the form, but performance information is available in other reports and registration statements filed with the SEC.</p>	<p>position information for positions comprising 5% or more of each pool's net asset value, and the identification of the pool's key relationships with brokers, other advisers, administrators, custodians, auditors and marketers. Part 2 also would require disclosure regarding each pool's quarterly and monthly performance information and information regarding participant subscriptions and redemptions.</p>	<p>Form N-SAR and proposed Form CPO-PQR, these differences generally reflect the fact that Form CPO-PQR is intended to obtain information relating to systemic risk, a concern that in our strongly held view is not raised by the activities of registered investment companies that are the subject of this letter. SEC proposed Form PF, which the CFTC has stated solicits information that is generally identical to that sought by Form CPO-PQR, is specifically designed to address the potential systemic risk raised by activities of advisers to private funds, not registered investment companies. However, registered investment companies are subject to CFTC large trader reporting requirements like any other trader, which enables the CFTC to obtain information from those entities that it can use to assess systemic risk.</p>
<p>Investment companies must complete the entire Form N-SAR regardless of assets under management. In addition, the form must be completed on a series by series basis. In general, Form N-SAR requires the name of each series (Item 7); information regarding each series' investment strategies and positions (Items 62-70); liabilities from borrowings and other portfolio management techniques (Item 74); and</p>	<p>CPOs that have assets under management equal to or exceeding \$150 million would be required to file Schedule B, which would require the CPO to report detailed information for each pool. The required information is comparable to that required by the corresponding provisions of Form N-SAR for funds and includes information regarding each pool's investment strategy, borrowings by geographic area</p>	<p>Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement.</p>

SEC Requirement	CFTC Requirement	Recommended Result
information regarding brokerage transactions (Items 20-26).	and the identities of significant creditors, credit counterparty disclosure, and entities through which the pool trades and clears its positions.	
Form N-SAR generally requires a registered investment company to report investment and exposure information on a series by series basis in all cases. It generally does not require an investment company to report investment and exposure information on an aggregate basis or certain more detailed information required by Schedule C of Form CPO-PQR.	Form CPO-PQR Schedule C, Parts 1 and 2 – CPOs that have assets under management equal to \$1 billion or more would be required to file Schedule C. Part 1 would require certain aggregate information about the commodity pools advised by large CPOs, such as the market value of assets invested, on both a long and short basis, in different types of securities and derivatives, turnover in these categories of financial instruments, and the tenor of fixed income portfolio holdings. Part 2 would require CPOs to report detailed information regarding individual pools with at least \$500 million in assets under management, including liquidity, concentration, material investment positions, collateral practices with significant counterparties and clearing relationships.	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement. Registered investment companies are subject to CFTC large trader reporting requirements like any other trader, which enables the CFTC to obtain information from those entities that it can use to assess systemic risk. Accordingly, the more detailed information requested by Form CPO-PQR, Schedule C should not be necessary for registered investment companies.

Books and Records:

SEC Requirement	CFTC Requirement	Recommended Result
Rule 31a-2 requires a registered investment company to preserve its books and records for specified periods of time, with more recent books and records typically preserved in an “easily accessible place.” Rule 31a-3	Rule 4.23 requires a CPO to maintain required pool books and records at its main business office.	We request that the CFTC grant exemptive relief to adviser CPOs from Rule 4.23 if they satisfy the requirements of the Investment Company Act rules and Form ADV.

SEC Requirement	CFTC Requirement	Recommended Result
<p>permits a registered investment company to use a third party to prepare and maintain required records. Reliance on the rule is conditioned upon having a written agreement to the effect that the records are the property of the person required to maintain and preserve them, and that such records will be surrendered promptly on request. In addition, Item 1(K) of Form ADV requires a registered investment adviser to indicate whether it maintains its required books and records at a location other than its principal office and place of business, and Section 1.K. of Schedule D of Form ADV requires the adviser to specify each entity that maintains its books and records, including the location of the entity, and a description of the books and records maintained at that location.</p>		



1401 H Street, NW, Suite 1200
Washington, DC 20005-2148
Phone 202/326-8300
Fax 202/326-5828
www.idc1.org

April 12, 2011

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

Re: Commodity Pool Operators and Commodity Trading Advisors: Amendments to
Compliance Obligations; RIN 3038—AD30

The Independent Directors Council (“IDC”)¹ appreciates the opportunity to comment on the Commodity Futures Trading Commission’s (“Commission”) proposal to modify the criteria for registered investment companies (“funds”) to claim exclusion from the definition of the term “commodity pool operator” (“CPO”) under the Commodity Exchange Act (“CEA”) in accordance with Rule 4.5 of the Commission’s regulations.² Fund directors and trustees oversee the management and operation of funds on behalf of over 90 million shareholders and have a unique perspective on the fund regulatory framework and the protections it provides to investors.³ The Commission’s proposal raises numerous issues and concerns for funds that provide shareholders with some degree of exposure to commodity futures, commodity options, and swaps as part of diversified, securities-based investment

¹ IDC serves the fund independent director community by advancing the education, interaction, communications, and policy interests of fund independent directors. IDC’s activities are led by a Governing Council of independent directors of Investment Company Institute member funds. ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of \$13 trillion and serve over 90 million shareholders, and there are approximately 2,000 independent directors of ICI member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

² Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 76 Fed. Reg. 7975 (Feb. 11, 2011).

³ An investment company may be organized as a corporation, with a board of directors, or as a business trust, with a board of trustees. This letter’s references to “fund directors” refer to both directors and trustees of registered investment companies.

portfolios. Those issues will be addressed by other commenters, including the Investment Company Institute.⁴ IDC will focus its comments on the potential implication of the proposal for fund directors.

Rule 4.5 currently excludes certain “otherwise regulated entities,” including funds, from CPO regulation if the entity files a notice of eligibility with the National Futures Association that includes certain representations. Prior to 2003, the notices of eligibility had to include representations that the use of commodity futures and commodity options for non-*bona fide* hedging purposes would be limited to five percent of the liquidation value of the qualifying entity’s portfolio and that the entity would not market the fund as a commodity pool to the public. In 2003, the Commission eliminated those restrictions. When the Commission announced its intention to remove the limits on commodity interest trading, it stated that the amendments were intended to allow greater flexibility and innovation and to encourage and facilitate participation in the commodity interest markets, with the added benefit to all market participants of increased liquidity.⁵ Following its review of the comments filed on the proposed amendments, the Commission determined also to eliminate the marketing restrictions, recognizing that the “otherwise regulated” nature of the qualifying entities would provide adequate customer protection.⁶

The Commission now proposes to reinstate the pre-2003 trading and marketing restrictions, with some additional constraints (*e.g.*, the restrictions would extend to a fund’s positions in swaps, in addition to its positions in commodity futures and commodity options). Under the proposed amendments, funds would have to restrict their exposures to commodity futures, commodity options, and swaps and comply with the marketing restrictions or the exclusion from CPO regulation provided by Rule 4.5 would not be available.

The Commission acknowledges that the structure of funds may result in operational difficulties with respect to compliance with CPO regulations. Indeed, because of their different structure, funds do not fit neatly within the CPO regulatory regime. While a CPO may be an individual or organization that operates a commodity pool and solicits funds for that commodity pool, a fund is itself a pool of assets that is managed by an adviser, pursuant to an advisory contract, and overseen by a fund board. Because a fund has no employees, it relies on the adviser and other service providers to run the

⁴ See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission regarding Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, RIN 3038-AD30 (April 12, 2011) (“ICI Letter”).

⁵ Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors, 68 Fed. Reg. 12622, 12625 (March 17, 2003).

⁶ Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues, 68 Fed. Reg. 47221, 47223 (August 8, 2003).

fund's day-to-day operations. The board oversees the performance of those entities under their respective contracts and monitors potential conflicts of interest.

The Commission's proposing release is silent regarding which entity—the fund, its investment adviser, or its directors—would be required to register as a CPO where the Rule 4.5 exclusion is not available. IDC agrees with ICI's assertion that, where the Rule 4.5 exclusion is not available, the adviser—and not the fund or its directors—is the appropriate entity to serve as the fund's CPO, for the reasons discussed in ICI's letter.⁷ To avoid any confusion on this matter, IDC urges the Commission to make the following clear: that fund directors would not be required to register as CPOs and would not be subject to regulation as CPOs where a fund does not qualify for the Rule 4.5 exclusion.

When the Commission adopted Rule 4.5 in 1985, it addressed the issue of how to determine the individual or entity that is acting as a CPO with respect to a commodity pool. As examples, it referred to these factors: (i) who is the individual or entity that will be promoting the pool by soliciting, accepting or receiving from others, funds or property for the purpose of commodity interest trading; (ii) who is the individual or entity that will have the authority to hire (and to fire) the pool's commodity trading advisor; and (iii) who will have the authority to select (and to change) the futures commission merchant ("FCM") that will carry the pool's commodity interest trading account.⁸

Looking at these factors, it seems evident that the Commission was not contemplating that fund independent directors would register as CPOs.⁹ Fund independent directors do not solicit, accept, or receive investments from others for the purpose of commodity interest trading, nor are they primarily responsible for selecting the FCM that will carry the fund's commodity interest trading account. Rather, these functions typically are carried out by the fund's sponsor (which is typically its investment adviser) and other service providers (such as the fund's principal underwriter) because, as noted above, funds do not have any employees and rely on their investment advisers and other service providers for the day-to-day management of, and decisions regarding, the fund. In this connection, fund boards serve an oversight role and monitor the performance of the fund's service providers. In addition, fund directors have the authority to approve and terminate a fund's agreement with its investment adviser (which typically also would be considered the commodity trading advisor), although termination is a drastic and costly step and generally inconsistent with the expectations of shareholders, who presumably invested in the fund based upon the adviser's investment strategy and performance record.

⁷ See ICI Letter, *supra* n. 4.

⁸ See Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Pool Operator"; Other Regulatory Requirements, 50 Fed. Reg. 15868 at n.26 (Apr. 23, 1985).

⁹ An independent director of a fund is not affiliated with the adviser and does not otherwise fall within the definition of "interested" director under Section 2(a)(19) of the Investment Company Act of 1940 ("1940 Act").

The Commission has previously recognized that registration of individual directors and trustees is not practicable or necessary.¹⁰ The same may be said in this instance. The policy rationale for the Commission's proposal (*i.e.*, to stop the practice of funds offering futures-only investment products without Commission oversight) would not be furthered by subjecting individual fund directors to Commission regulation. Moreover, requiring fund directors to register as CPOs is wholly inconsistent with their oversight role. Fund directors *oversee* the management and operation of funds on behalf of fund shareholders; they do not directly "manage" or "operate" the fund. Requiring a director to comply with the requirements of a CPO, such as to pass a fitness test and the Series 3 exam, would impose unnecessary and burdensome obligations on directors for no apparent reason.¹¹ Clearly, these requirements are not related or relevant to their oversight responsibilities. Fund directors are already subject to significant and important responsibilities that are appropriately tailored to their oversight role.¹² The added and unnecessary burden of CPO registration and regulation could very likely deter qualified persons from serving as fund directors, to the detriment of fund shareholders.

Fund shareholders are well protected by the oversight provided by fund boards, and will continue to be protected, regardless of whether the adviser or the fund itself is registered as a CPO. Fund directors are subject to state law fiduciary duties of loyalty and care, in addition to the responsibilities imposed on them under the federal securities laws. Most boards are composed of at least 75 percent independent directors,¹³ and, according to the Supreme Court, these directors have "the primary responsibility" for looking after the interests of the fund's shareholders and serve as "independent watchdogs" on their behalf.¹⁴

Because there are no policy reasons to require independent directors to register as CPOs, and there are numerous detrimental consequences in doing so, IDC urges the Commission to clarify that

¹⁰ See CFTC Letter No. 10-06, No Action Exemption (March 29, 2010) (concerning directors of commodity exchange traded funds that were not registered investment companies under the 1940 Act).

¹¹ Persons may not serve as fund directors if they are subject to any disqualifications in Section 9 of the 1940 Act.

¹² The 1940 Act requires fund directors, and separately, independent directors, to annually review and approve the advisory contract. Fund boards are also tasked with, among others, approving the auditor and principal underwriter for the fund and making fair value determinations for certain securities held by the fund. Securities and Exchange Commission rules further require boards to oversee a variety of transactions involving potential conflicts of interest between the fund and its investment adviser or the adviser's affiliates. Boards also oversee the audit and compliance functions, and must approve written compliance policies and procedures designed to prevent violations of federal securities laws.

¹³ See *Overview of Fund Governance Practices, 1994-2008* (available at http://www.idc.org/pdf/pub_09_fund_governance.pdf).

¹⁴ See *Burks v. Lasker*, 441 U.S. 471, 484-85 (1979).

Mr. David A. Stawick

April 12, 2011

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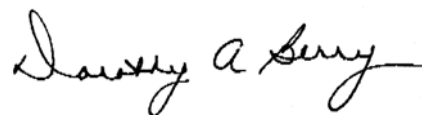
fund independent directors are not required to (1) register as CPOs, or (2) comply with the CPO provisions of the CEA and the rules thereunder where the fund does not meet the criteria for the exclusion provided by Rule 4.5.

For the same reasons, IDC urges the Commission to clarify that the independent directors of funds would not be deemed to be principals or associated persons of a CPO where the fund does not meet the criteria for the exclusion provided by Rule 4.5. If the adviser is deemed the CPO, independent directors should not be treated as principals or associated persons, because they are not and cannot be affiliated with the adviser. Indeed, if, for example, the adviser is organized as a corporation, it may have its own board of directors that oversees the adviser's operations. If the fund itself is deemed the CPO—which, as noted above and discussed further in ICI's letter, IDC does not believe would be appropriate—the Commission's policy reasons for the proposal would not be furthered by imposing the additional, unnecessary burdens on individual independent directors who already have significant responsibilities on behalf of fund shareholders and, who, as previously noted, are already subject to disqualifications under the 1940 Act.

* * *

If you have any questions about our comments, please contact Amy B.R. Lancellotta, Managing Director, at (202) 326-5824.

Sincerely,



Dorothy A. Berry
Chair, IDC Governing Council

Cc: The Honorable Gary Gensler, Chairman
The Honorable Michael V. Dunn, Commissioner
The Honorable Jill E. Sommers, Commissioner
The Honorable Bart Chilton, Commissioner
The Honorable Scott D. O'Malia, Commissioner

Kevin P. Walek, Assistant Director

Mr. David A. Stawick

April 12, 2011

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Amanda Lesher Olear, Special Counsel
Daniel S. Konar II, Attorney-Adviser
Division of Clearing and Intermediary Oversight

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

Eileen Rominger, Director
Division of Investment Management, SEC



TESTIMONY OF KARRIE MCMILLAN

GENERAL COUNSEL

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT

COMMITTEE ON AGRICULTURE

UNITED STATES HOUSE OF REPRESENTATIVES

ON

“IMPLEMENTING DODD-FRANK: A REVIEW OF THE CFTC’S RULEMAKING PROCESS”

APRIL 13, 2011

EXECUTIVE SUMMARY

- Registered investment companies, or “funds,” use swaps and other derivatives in a variety of ways. ICI and its members thus have a strong interest in ensuring that the new regulatory framework for the derivatives markets supports and fosters markets that are highly competitive, transparent, and liquid.
- ICI commends the CFTC and SEC for their diligence and dedication in the very difficult task of developing an appropriate regulatory framework and avoiding unintended consequences. We do, however, have concerns with the order in which rules have been published for public comment and the length of the respective comment periods. We also have urged the CFTC and SEC to phase-in application of new regulatory requirements over a reasonable period of time.
- ICI is particularly concerned with the CFTC’s decision in late January to issue a sweeping proposal to revise or rescind several of its rules, including Rule 4.5, which currently provides an exclusion for funds and certain “otherwise regulated” entities from regulation as commodity pool operators. The proposal is *not* mandated or even contemplated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. And its issuance at this time is most unfortunate, because it has diverted attention away from the effort to implement the provisions of the Dodd-Frank Act.
- The proposed amendments to Rule 4.5 are premature and insufficiently developed. For example, the CFTC proposes a key trading restriction that would relate to margin levels on derivatives positions. ICI and its members cannot assess the full impact of this proposed restriction because it is not yet known which swaps will be subject to central clearing, what the margin requirements will be for cleared and uncleared swaps, and whether foreign exchange forwards and foreign exchange swaps will be exempted from the definition of “swap.”
- If adopted in their current form, the proposed amendments to Rule 4.5 would subject funds – which are already subject to comprehensive regulation under all four of the major federal securities laws – to duplicative and fundamentally inconsistent regulatory requirements. The CFTC has failed to demonstrate the need for imposing a second layer of regulation on funds. Moreover, its cursory cost-benefit analysis is wholly inadequate to justify the costly and burdensome regulation contemplated by the proposed amendments.
- Even if the proposed amendments to Rule 4.5 are appropriately scaled back, there are likely to be some funds (and their investment advisers) that would become subject to CFTC regulation. It is essential that the CFTC work closely with the SEC to reconcile the duplicative and conflicting regulatory requirements to which these funds would become subject, and to re-propose the harmonized regulations for public comment.

I. INTRODUCTION

My name is Karrie McMillan. I am General Counsel of the Investment Company Institute, the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). For ease of discussion, we refer in this testimony to all registered investment companies as “funds.” Members of ICI manage total assets of \$13.0 trillion and serve over 90 million shareholders.

ICI is pleased to offer its perspectives on rulemaking by the Commodity Futures Trading Commission (CFTC or Commission) to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). We also provide our views on the CFTC’s recent decision to issue a sweeping proposal to modify or rescind several of its exemptive and exclusionary rules, a proposal that is not mandated (or even contemplated) by the Dodd-Frank Act. The proposed amendments to one of those rules – CFTC Rule 4.5 – are premature and insufficiently developed. If adopted in their current form, those amendments would subject a large segment of the fund industry – which is already subject to comprehensive regulation – to duplicative and fundamentally inconsistent regulatory requirements.

II. ICI VIEWS ON CFTC RULEMAKING TO IMPLEMENT THE DERIVATIVES REFORM PROVISIONS OF THE DODD-FRANK ACT

Like many financial institutions, funds use swaps and other derivatives in a variety of ways. They are a particularly useful portfolio management tool in that they offer funds considerable flexibility in structuring their investment portfolios. Uses of swaps and other derivatives include, for example, hedging positions, equitizing cash that a fund cannot immediately invest in direct equity holdings (*e.g.*,

if the stock market has already closed for the day), managing the fund's cash positions more generally, adjusting the duration of the fund's portfolio (*e.g.*, by seeking to maintain a bond fund's stated duration of seven years as its holdings in fixed-income securities age or mature), managing bond positions in general (*e.g.*, in anticipation of expected changes in monetary policy or the Treasury's auction schedule), or managing the fund's portfolio in accordance with the investment objectives stated in its prospectus.

Implementation of the Dodd-Frank Act will dramatically change financial regulation in the United States by, among other things, establishing a new regulatory framework for the derivatives markets and participants in those markets.¹ ICI and its members have a strong interest in ensuring that the derivatives markets are highly competitive and transparent, and that the regulation governing them encourages liquidity, fairness and transparency. ICI has therefore been closely monitoring the work of the CFTC and the Securities and Exchange Commission (SEC) as the agencies seek to develop this framework, and we have provided comment on a number of their rule proposals.²

Developing the appropriate regulatory framework for derivatives and avoiding unintended consequences is a very difficult task. It is one that requires thoughtful and comprehensive analysis, a deliberative approach, coordination between the CFTC and SEC when possible and appropriate, and careful consideration of comments and recommendations from the public. From time to time,

¹ ICI was an early supporter of federal legislation to close this regulatory gap. *See, e.g.*, Investment Company Institute, *Financial Services Regulatory Reform: Discussion and Recommendations* (March 3, 2009), available at http://www.ici.org/pdf/ppr_09_reg_reform.pdf.

² *See, e.g.*, Letters from Karrie McMillan, General Counsel, ICI to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated Sept. 20, 2010 and Feb. 22, 2011 (regarding the definition of key terms in the Dodd-Frank Act related to the regulation of swaps); Letters from Karrie McMillan, General Counsel, ICI to Elizabeth M. Murphy, Secretary, SEC, dated Jan. 18, 2011 and to David A. Stawick, Secretary, CFTC, dated Feb. 7, 2011 (regarding real-time reporting of swap transaction data); Letters from Karrie McMillan, General Counsel, ICI to David A. Stawick, Secretary, CFTC, dated Jan. 18, 2011 (regarding protection of customer collateral for cleared swaps) and Feb. 1, 2011 (regarding protection of customer collateral for uncleared swaps).

reproposals of certain rules may be necessary to ensure that they are workable and do not impose costs that are not justified by their benefits.

Getting the rules right is critical for protecting the swaps markets, market participants, and the broader financial system. And, in our view, the agencies have a much harder time getting the rules right if the public is limited in its ability to provide meaningful comment on proposed rules because of overly short comment periods or the order in which the rules are proposed.

Last December, ICI joined with nine other trade associations in sending a joint letter to the CFTC and SEC on their efforts to implement the derivatives provisions of the Dodd-Frank Act.³ The letter began by commending the agencies “for their diligence and dedication with regard to this unprecedented rulemaking endeavor.” It noted, in particular, that the Dodd-Frank Act imposes “short and strict deadlines” on each agency, and that many of the required rules “concern activities and products that are complex and new to regulatory oversight.”

The joint letter did, however, raise concerns with aspects of the rulemaking process being followed by the two agencies and recommended certain changes. Among other issues, the letter expressed concern with the order in which the rules have been published for public comment. A prime example of this was the agencies’ issuance of proposed requirements for “swap dealers” and “major swap participants” before they had proposed how these Dodd-Frank Act terms should be defined.

Uncertainty regarding who might be covered by the proposed requirements made it very difficult for

³ See Letter from American Bankers Ass’n, ABA Securities Ass’n, The Clearing House Ass’n, L.L.C., Financial Services Forum, Financial Services Roundtable, Institute of International Bankers, International Swaps and Derivatives Ass’n, Investment Company Institute, Managed Funds Ass’n and Securities Industry and Financial Markets Ass’n to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated Dec. 6, 2010.

firms to know whether and to what extent the requirements might apply to them, and thus whether and how to provide meaningful comment.

The joint letter also expressed concern that participants in the derivatives markets “would be asked to do too much in too short a time” in regard to implementing new rules. It cautioned that market participants might be forced to refrain from derivatives transactions for which compliance was not possible, which could in turn cause there to be little or no liquidity in certain segments of the market. The letter noted that the Dodd-Frank Act sets only a floor for the effective date for implementing rules (*i.e.*, “not less than 60 days after publication”) and, accordingly, called on the CFTC and SEC to use their discretion in order to “phase-in the application of new regulatory requirements over a reasonable period of time, determined through discussions with the market participants that the agencies expect to be directly affected by those requirements.” We are pleased that Chairman Gensler recently acknowledged that Congress “gave the CFTC broad latitude in determining when final rulemakings [under the Dodd-Frank Act] would become effective” and that the agency “may give market participants more time” to comply than the 60-day floor described above.⁴

As this Committee continues to oversee the CFTC’s implementation of the Dodd-Frank Act, we urge you to encourage the agency to facilitate meaningful public comment on these important rule proposals, to consider those comments fully in their rulewriting effort and, once those rules are finalized, to allow the private sector sufficient time to come into compliance.

⁴ See Gary Gensler, Chairman, CFTC, Remarks, *Implementing the Dodd-Frank Act*, at the Futures Industry Association’s Annual International Futures Industry Conference, Boca Raton, FL (March 16, 2011).

III. CFTC PROPOSAL TO MODIFY OR RESCIND SEVERAL EXEMPTIVE AND EXCLUSIONARY RULES, INCLUDING RULE 4.5

A. ICI Views on the Proposal Generally

In late January, the CFTC voted to issue a sweeping proposal to revise or rescind several of its exemptive and exclusionary rules, as well as adopt new disclosure requirements, in an effort to “more effectively oversee its market participants and manage the risks that such participants pose to the markets.”⁵ In particular, the proposal would rescind the exemptions from regulation as a commodity pool operator (CPO) on which sponsors of private investment funds typically rely, significantly narrow the exclusion from CPO regulation in Rule 4.5 under the Commodity Exchange Act as it relates to funds (discussed in detail below), and impose new periodic reporting requirements on all CPOs and commodity trading advisors registered with the CFTC.

Not surprisingly, a proposal of this nature and scope, if adopted, would have significant implications for many asset management firms – and this would be *in addition* to the many new obligations imposed on these firms by the Dodd-Frank Act. Because of this, ICI and other stakeholders have spent considerable time analyzing the proposal and in particular, the amendments to Rule 4.5, and have developed some recommendations for how it might be appropriately amended.

For many reasons, the timing of this proposal is most unfortunate. The proposal is not mandated by the Dodd-Frank Act, although the CFTC attempts to describe it as being “consistent with the tenor” of that Act.⁶ Its publication for comment has required ICI and other stakeholders to

⁵ See *Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations*, 76 Fed. Reg. 7976 (Feb. 11, 2011) (“Release”).

⁶ *Id.* At 7977.

divert attention away from analyzing and commenting on the many proposals from the CFTC, SEC and other agencies to implement the Dodd-Frank Act.⁷ The proposal has likewise been a diversion for the CFTC and its staff.

It is also important to note that any adoption of the proposal in its current form would have considerable long-term implications for the CFTC. A host of new registrants would increase the agency's workload, and regulatory oversight of these new registrants would strain its limited resources, at a time when the agency acknowledges that it does not have the staffing or budget to meet new responsibilities under the Dodd-Frank Act.⁸ It likewise would strain the resources of the National Futures Association (NFA), which serves as the frontline regulator for CPOs.

B. ICI Views on the Proposed Amendments to CFTC Rule 4.5

Rule 4.5 currently provides an exclusion for certain "otherwise regulated entities," including funds, from regulation as CPOs. The proposed amendments would condition eligibility for the Rule 4.5 exclusion on compliance with certain trading and marketing restrictions.⁹ Funds unable to satisfy these conditions would be subject to regulation and oversight by the CFTC and the NFA. This would impose a second layer of regulation on such funds, which already must comply with comprehensive

⁷ The CFTC first published a petition for rulemaking from the National Futures Association on September 17, 2010. *See Petition of the National Futures Association, Pursuant to Rule 13.2, to the U.S. Commodity Futures Trading Commission to Amend Rule 4.5*, 75 Fed. Reg. 56997. ICI and others commented extensively on that petition. On February 11, 2011, the CFTC published the proposal in question, seemingly without taking into account the commenters' myriad concerns raised during the first comment period.

⁸ *See* Testimony of Gary Gensler, Chairman, CFTC, Before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, Committee on Appropriations, United States House of Representatives, on the CFTC's budget request for FY2012 (March 17, 2011) (stating that the Commission's current funding level is "simply not sufficient for the CFTC's expanded mission to oversee both the futures and swaps markets.").

⁹ The topics covered in this section are discussed in extensive detail in ICI's comment letter on the proposal. This letter was filed with the CFTC on April 12, 2011, and we will submit a copy of this letter to the Committee for inclusion in the hearing record.

regulatory requirements under the Investment Company Act of 1940 (Investment Company Act) and other federal securities laws.

1. The CFTC Has Not Justified the Broad Scope of the Proposed Amendments

The Release states that the amendments to Rule 4.5 are intended to “stop the practice of registered investment companies offering futures-only investment products without Commission oversight . . .”¹⁰ The Release fails to explain, however, why the proposed amendments are troublingly broader in reach. Specifically, the sweeping language of the proposed trading and marketing conditions would implicate a large number of funds that use futures, options and swaps simply as a means to efficiently manage their portfolios, rather than as part of operating a “futures-only” fund. It is difficult to justify this result at a time when, as noted above, the CFTC Chairman has stated that current funding levels for the agency are “simply not sufficient” and is requesting substantial additional resources from Congress.¹¹

2. The CFTC Has Not Demonstrated the Need for Imposing a Second Layer of Regulation on Funds

In its Release, the CFTC provides no evidence that a “futures-only” fund – not to mention a fund using futures, options or swaps for reasons *other than* providing exposure to the commodities markets – is currently subject to inadequate regulation, or that investors or the commodity markets generally have been harmed by their practices.

¹⁰ Release, *supra* note 5, at 7984.

¹¹ See *supra* note 8.

In fact, funds are already extensively regulated. They are the only financial institutions that are subject to all of the four major federal securities laws. The Securities Act of 1933 and the Securities Exchange Act of 1934 regulate the public offering of shares and ongoing reporting requirements, respectively. Funds must provide comprehensive disclosure to investors in plain English, including with regard to fees and expenses, the fund's investment objectives, and the risks of investing in the fund. The Investment Company Act regulates a fund's structure and operations, and addresses fund capital structures (including limits on use of leverage), custody of assets, investment activities (particularly with respect to transactions with affiliates and other transactions involving potential conflicts of interest), and the composition and duties of fund boards. A fund's investment adviser must register with the SEC and comply with the provisions of the Investment Advisers Act of 1940. Funds and their advisers are subject to antifraud standards. Finally, the federal securities laws provide the SEC with inspection authority over funds and their investment advisers, principal underwriters, distributing broker-dealers and transfer agents. The Financial Industry Regulatory Authority (FINRA) also has oversight authority with regard to funds' principal underwriters and distributing broker-dealers.

As a result, ICI questions why the CFTC believes it is necessary to impose an additional, costly layer of regulation on these already heavily regulated entities.

3. Because the Regulatory Regime for Swaps is Still Being Developed, the Fund Industry and Other Interested Parties Cannot Adequately Assess the Impact of This Proposal

It is difficult at this time to assess the full impact of, and meaningfully comment on, the proposed amendments to Rule 4.5. This is because one of the key conditions would relate to margin levels on derivative positions held by funds, and the regulators have not yet made critical determinations that relate to swap margin levels. Specifically, the CFTC and SEC have not finalized

rules regarding which swaps will be subject to central clearing requirements. In addition, margin requirements have not been established for cleared or uncleared swaps (which could end up varying significantly based on the type of swap). Finally, we do not yet know whether the Department of the Treasury will exempt foreign exchange forwards and foreign exchange swaps from the definition of “swap” and, if no exemption is granted, what the margin requirements would be for these instruments.

It is our strongly held view that the new regulatory framework for swaps must be put in place and margin requirements for both centrally cleared and uncleared swaps established *before* the Commission can propose any amendments to Rule 4.5 that implicate the use of swaps.

4. The CFTC Has Not Adequately Analyzed the Potential Costs and Benefits of Its Proposal

We believe that the CFTC’s cursory analysis of the costs and benefits of the proposed amendments to Rule 4.5 is wholly inadequate to justify the costly and burdensome regulation they would impose on a large portion of the fund industry. The CFTC does identify a few costs, which it does not detail or quantify, but it fails to identify many of the major costs the proposal would impose on funds, some of which would inevitably get passed on to shareholders. The CFTC’s analysis of benefits is even more abstract and does not appear to be focused on the proposed amendments to Rule 4.5. Importantly, the Commission fails to acknowledge in its analysis that any benefits that fund shareholders may receive as a result of these amendments would largely duplicate many protections they currently enjoy as a result of the Investment Company Act and other federal securities laws.

We have deep concerns whether the CFTC's cost-benefit analysis would satisfy the applicable requirements of the Commodity Exchange Act,¹² and we believe that the agency should not adopt any amendments to Rule 4.5 without conducting a more comprehensive analysis. We further question whether it is even possible for the CFTC to conduct an adequate analysis until the status and margin issues regarding swaps, mentioned above, have been resolved, as the resolution of those issues could vastly impact the number of funds that may be swept into the CFTC's jurisdiction.

ICI is not alone in its concerns. The Chairman of this Subcommittee, together with the Committee Chair, recently raised very similar concerns in requesting that the CFTC's inspector general undertake an investigation of the adequacy of the Commission's cost-benefit analysis.¹³ We particularly agree with their observations that:

the CFTC is failing to adequately conduct cost-benefit analysis – either as required by the [Commodity Exchange Act] or the principles of the Executive Order [on Improving Regulation and Regulatory Review]. . . . [p]articularly during tough economic times, it is incumbent upon the CFTC to approach cost-benefit thoroughly and responsibly to understand the costs, and therefore the economic impact any proposed regulation will have on regulated entities and markets.

¹² Section 15(a) of the Commodity Exchange Act requires the CFTC to consider the costs and benefits of its actions before issuing rules, regulations or orders. Section 15(a) requires the CFTC to evaluate the costs and benefits in light of the following five areas: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations.

¹³ See Letter from Frank D. Lucas, Chairman, Committee on Agriculture, and K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk Management, to A. Roy Lavik, Inspector General, CFTC dated Mar. 11, 2011.

Even members of the Commission have raised concerns about the manner in which the agency conducts its cost-benefit analysis. Commissioner Sommers, for example, has observed that:

the proposals we have voted on over the last several months [] contain very short, boilerplate ‘Cost-Benefit Analysis’ sections. . . . how can we appropriately consider costs and benefits if we make no attempt to quantify what the costs are? . . . Clearly, when it comes to cost-benefit analysis the Commission is merely complying with the absolute minimum requirements of the Commodity Exchange Act. That is not in keeping with the spirit of the President’s recent Executive Order on ‘Improving Regulation and Regulatory Review.’ We owe the American public more than the absolute minimum.¹⁴

5. The CFTC’s Proposal Would Impose Inconsistent and Duplicative Regulation on Funds

Finally, even if the restrictions in the proposed amendments to Rule 4.5 are appropriately scaled back, there are likely to be cases in which funds and their advisers would be unable to rely on the amended rule and thus would become subject to regulation by both the CFTC and the SEC. The Release specifically acknowledges that funds may have difficulty complying with some of the CFTC’s regulations, yet it does not propose any solutions. As part of our analysis of the Commission’s proposal, ICI and its outside counsel have compared the CFTC and SEC regulatory regimes under the Investment Company Act and the Commodity Exchange Act, respectively. This analysis is summarized in a detailed appendix to our April 12 comment letter.¹⁵ As this appendix demonstrates,

¹⁴ See Jill E. Sommers, Commissioner, CFTC, Opening Statement, Meeting on the Twelfth Series of Proposed Rulemakings under the Dodd-Frank Act (Feb. 24, 2011).

¹⁵ See *supra* note 9.

many of the CFTC's requirements would be duplicative of the requirements to which funds and their advisers are already subject under the Investment Company Act or other federal securities laws. Other of the CFTC's requirements would be fundamentally inconsistent with the requirements to which funds and their advisers are subject.

For example, the SEC significantly limits the ability of a fund to include in its prospectus performance information about other funds or accounts managed by the fund's adviser.¹⁶ The CFTC rules, by contrast, *require* disclosure of such information in certain circumstances. A fund could not comply with the CFTC's requirements without likely violating the SEC's (and FINRA's) requirements. As another example, the CFTC rules regarding delivery and receipt of a commodity pool disclosure document are fundamentally different than the model under the federal securities laws, and would not be practicable for funds, which generally offer their shares publicly on a daily basis through broker-dealers and other intermediaries.

The examples above illustrate why we believe it is absolutely critical that the CFTC, before imposing an *additional* regulatory requirement on funds, evaluate its regulatory purpose in doing so and consider whether a regulation to which funds and their advisers are *already* subject would be sufficient to satisfy that purpose.

More broadly, it is essential that the CFTC work closely with the SEC before amending Rule 4.5 in order to reconcile the many duplicative and conflicting regulations to which a fund and its adviser could become subject. The harmonized regulations then should be re-proposed for public comment.

¹⁶ FINRA, which has oversight over fund advertising, similarly prohibits funds from advertising the adviser's other fund or account performance.

IV. CONCLUSION

We appreciate this opportunity to testify before the Committee. The regulatory proposals discussed in our testimony have important implications for funds and the over 90 million shareholders who rely on funds to meet their retirement and investment goals. Continued Congressional oversight of the CFTC's work on these proposals is critical to ensuring that the regulatory scheme for the derivatives markets is appropriately established and that funds are not made subject to duplicative and fundamentally inconsistent regulatory requirements.