The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 25107

April 14, 2011

ICI and IDC Comment Letters on CFTC Proposal to Narrow Rule 4.5 Exclusion for Funds; ICI Congressional Testimony on Rule 4.5 Proposal and Dodd-Frank Implementation

[25107]

April 14, 2011

TO: BOARD OF GOVERNORS No. 2-11
CLOSED-END INVESTMENT COMPANY MEMBERS No. 33-11
DERIVATIVES MARKETS ADVISORY COMMITTEE
ETF ADVISORY COMMITTEE No. 24-11
FIXED-INCOME ADVISORY COMMITTEE No. 31-11
SEC RULES MEMBERS No. 50-11
SMALL FUNDS MEMBERS No. 31-11 RE: ICI AND IDC COMMENT LETTERS ON CFTC PROPOSAL TO NARROW RULE 4.5 EXCLUSION FOR FUNDS; ICI CONGRESSIONAL TESTIMONY ON RULE 4.5 PROPOSAL AND DODD-FRANK IMPLEMENTATION

As we previously informed you, the Commodity Futures Trading Commission (CFTC or Commission) has proposed to revise or rescind several of its 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." [1] Among the affected rules is Rule 4.5, under which a registered investment company (fund) may claim an exclusion from regulation as a commodity pool operator (CPO). The proposed amendments would condition this exclusion on a fund's adherence to certain trading and marketing restrictions applicable to its positions in commodity futures, commodity options, and swaps. ICI has submitted a lengthy comment letter on the proposal. IDC has submitted a more focused letter, in which it urges the CFTC to clarify that a fund's directors would not be subject to CPO registration if the fund could not rely on the Rule 4.5 exclusion. In addition, ICI voiced its concerns about the proposed amendments to Rule 4.5 in testimony before the House Agriculture Committee's Subcommittee on General Farm Commodities and Risk Management (Subcommittee).

Set forth below are the executive summaries from ICI's comment letter and ICI's written testimony to the Subcommittee and a brief summary of the IDC comment letter. All three documents are attached to this memorandum.

Executive Summary from ICI's Comment Letter

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:

- 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. [2] 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.

IDC Comment Letter

IDC's letter observes that the 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. The letter expresses agreement 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. IDC urges the CFTC 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.

Referring to factors the CFTC had previously articulated for determining the individual or entity that is acting as a CPO (such as the individual or entity that will be promoting the commodity pool by soliciting, accepting or receiving from others, funds or property for the purpose of commodity interest trading), IDC asserts that it seems evident that the CFTC was not contemplating that fund directors register as CPOs. The letter states that the policy rationale for the CFTC'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 CFTC regulation. Requiring fund directors to register as CPOs also is wholly inconsistent with their oversight role. IDC's letter further asserts that 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. IDC also urges the CFTC to clarify that 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.

ICI Congressional Testimony

On April 13, Karrie McMillan, ICI's General Counsel, testified before the Subcommittee on the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the CFTC's rulemaking process. The other witnesses were: Dan Berkovitz, General Counsel of the CFTC; Terrence Duffy, Executive Chairman, CME Group Inc.; Hal Scott, Director, Committee on Capital Markets Regulation and Professor, Harvard Law School; Dr. James Overdahl, Vice President, National Economic Research Associates; and Michael Greenberger, Professor, University of Maryland School of Law. [3]

As outlined in the executive summary, ICI's written testimony conveyed the following points to the Subcommittee:

- Registered investment companies 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.

Sarah A. Bessin
Senior Counsel

Rachel H. Graham
Senior Associate Counsel

Attachment

endnotes

[1] Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (Jan. 26, 2010) (Release). For a summary of the CFTC's proposal, see ICI Memorandum 24947, dated Feb. 4, 2011.

[2] The comment letter includes a lengthy appendix that compares the various areas of duplicative and conflicting regulatory requirements, and offers recommended resolutions in each area.

[3] Written testimony of the witnesses is available on the Subcommittee's website at http://agriculture.house.gov/hearings/hearingDetails.aspx?NewsID=1357#Testimony.
