COMMENT LETTER

September 16, 2013

ICI Submits Follow-Up Letter to CFTC Staff Regarding Certain SEC Exemptive orders and No-Action Letters; NFA Makes Amended Compliance Rule 2-45 Effective

September 16, 2013 VIA ELECTRONIC MAIL Mr. Gary Barnett Director Division of Swap Dealer and Intermediary Oversight Commodity Futures Trading Commission Three Lafayette Centre 1155 21st Street, NW Washington, DC 20581 Re: Follow-up Letter on CFTC Regulation 4.20(c) Dear Mr. Barnett: The Investment Company Institute ("ICI")1 is submitting this letter to provide additional information regarding the request for confirmation we submitted on December 21, 2012.2 The December ICI Letter sought confirmation on behalf of ICI's members that transactions and arrangements permitted by exemptive orders and no-action letters issued by the Securities and Exchange Commission ("SEC" or "Commission") and its staff under Section 17 of the Investment Company Act of 1940 ("Investment Company Act") will be deemed not to implicate Commodity Futures Trading Commission ("CFTC") Regulation 4.20(c), which prohibits commingling by a commodity pool operator ("CPO") of the property of any pool it operates with the property of any other person. 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 $15.4 trillion and serve over 90 million shareholders. 2 See Letter to Gary Barnett, Director, Division of Swap Dealer and Intermediary Oversight, Commodity Futures Trading Commission, from Karrie McMillan, General Counsel, Investment Company Institute, dated December 21, 2012 ("December ICI Letter"). Mr. Gary Barnett September 16, 2013 Page 2 This letter addresses several issues you and your colleagues have raised with us since we submitted the December ICI Letter. Specifically, you requested additional information about the types of arrangements for which the SEC and its staff have granted exemptive or no-action relief that could potentially implicate CFTC Regulation 4.20(c), and the parameters under which the SEC and its staff have granted such relief. You also asked about whether a registered investment company ("fund") that relies on an SEC exemptive order or no-action letter must disclose the terms of the relief to fund shareholders. We note that, since we submitted the December ICI Letter, the CFTC adopted final harmonization rules for operators of funds that are subject to registration as CPOs.3 Our request that the CFTC staff confirm that transactions and arrangements permitted by SEC exemptive orders and no-action letters under Section 17 of the Investment Company Act, and Rule 17d-1 thereunder, be deemed not to implicate CFTC Regulation 4.20(c) is fully consistent with the "substituted compliance" approach taken by the CFTC in that rulemaking.4 CFTC Regulation 4.20(c) and Corresponding Protections Under the Investment Company Act CFTC Regulation 4.20(c) was adopted to protect pool participants from abuses of their funds at the hands of the CPO. As explained in the CFTC's proposing release on a predecessor regulation, "[t]he Commission, through investigations and enforcement proceedings, is aware of several instances in which the operation of a pool in a CPO's name and the commingling of pool property have resulted in abuses of customers' funds."5 Section 17 of the Investment Company Act addresses many of the same concerns as CFTC Regulation 4.20(c), as well as more broadly prohibiting self-dealing and other forms of overreaching of a fund by its affiliates. Although the Investment Company Act permits other arrangements,6 nearly all funds use a bank custodian for domestic securities. A fund's custody agreement with a bank is typically far more elaborate than the arrangements used for other bank clients and covers a range of services, including safekeeping, accounting and monitoring services for the fund's assets. The strict rules on the custody and reconciliation of fund assets are designed to protect funds and their shareholders against 3 See Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators, 78 Fed. Reg. 52308 (Aug. 22, 2013) ("final harmonization rules"). 4 "The Commission is adopting a substituted compliance regime for CPOs of RICs largely premised upon such entities' adherence to the compliance obligations under SEC RIC Rules, whereby the Commission will accept compliance by such entities with the disclosure, reporting, and recordkeeping regime administered by the SEC as substituted compliance with part 4 of the Commission's regulations." Id. at 52310. 5 See Revisions of Commodity Pool Operator and Commodity Trading Advisor Regulations; Proposed Rules, 45 Fed. Reg. 51600, 51604 (Aug. 4, 1980). 6Rule 17f-6 under the Investment Company Act, for example, prescribes the conditions pursuant to which funds may maintain cash, securities and similar investments with a futures commission merchant in amounts necessary to effect the fund's transactions in exchange-traded futures contracts and commodity options. Mr. Gary Barnett September 16, 2013 Page 3 theft and other fraud-based losses. Shareholders are further insulated from these types of losses by the requirement in Section 17(g) of the Investment Company Act that all mutual funds have fidelity bonds designed to protect them against possible instances of employee larceny or embezzlement. Other provisions of Section 17 address transactions and activities between the fund and affiliated entities. For example, Section 17(a) generally prohibits an affiliated person, or an affiliated person of an affiliated person (a "second-tier affiliate"), of a fund, acting as principal, from knowingly purchasing from or selling to the fund any security or other property. This section protects investors by prohibiting a purchase or sale transaction when a party to the transaction has both the ability and the pecuniary incentive to influence the actions of the fund. Likewise, Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder generally prohibit an affiliated person or second-tier affiliate of a fund, acting as principal, from participating in any joint enterprise, joint arrangement, or profit-sharing plan, as defined in the rule, without first obtaining an exemptive order from the SEC. These provisions are intended to protect investment companies from participating in transactions or arrangements with affiliated persons on inequitable terms, while recognizing that, if properly circumscribed to avoid inequitable terms, transactions with affiliated persons may benefit the fund and its shareholders. As discussed below, the SEC's exemptive process is designed to examine the particular facts of a proposed activity and address any potential concerns or conflicts that a transaction otherwise could raise. Indeed, the concept of exemptive orders (and other forms of exemption) is an integral part of the Investment Company Act framework, written into the Act in recognition of the difficulty of regulating a broad and diverse industry that necessarily will evolve over time. Exemptive Provisions and Process Under the Investment Company Act Exemptive provisions are a critical part of the Investment Company Act framework. Indeed, there are over 30 instances in which the Investment Company Act itself authorizes the SEC to issue orders for relief from statutory requirements,7 including one overarching provision, Section 6(c), which authorizes the SEC to: conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the 7 See Division of Investment Management, SEC, Protecting Investors: A Half Century of Investment Company Regulation 503 (1992) ("Protecting Investors"). Mr. Gary Barnett September 16, 2013 Page 4 protection of investors and the purposes fairly intended by the policy and provisions of [the Act].8 As the legislative history indicates, the intention of Congress was to provide the SEC with administrative flexibility, in light of "the difficulty of making provision for regulating an industry which has so many variants and so many different types of activities . . . "9 Exemptive orders are particular to the applicant(s) to which they are issued, and may not be relied upon by others, unlike SEC no-action letters, which generally may be relied upon by entities that meet the facts and circumstances of the letters, unless otherwise indicated. The exemptive order process begins with a comprehensive application by an applicant, setting forth the basis for the relief requested, including a detailed analysis of all relevant provisions of the Investment Company Act and a factual justification for exemption from particular statutory provisions. An applicant will typically engage in a review process with SEC staff, in which the staff will provide the applicant with detailed comments, to which the applicant must respond. This process may consistent of multiple rounds of comments, and may take months, if not years, to complete. Once such review is completed, a notice outlining the requested relief is published, providing the public with an opportunity to review the requested relief and request a hearing before the SEC on the propriety of granting the proposed relief. Exemptive orders must be issued by the SEC. The Division of Investment Management, however, may grant an order under delegated authority "where, upon examination, the matter does not appear to the Director to present significant issues that have not been previously settled by the Commission or to raise questions of fact or policy indicating that the public interest or the interest of investors warrants that the Commission consider the matter."10 At times, over the course of many years, the staff may consider and grant individual exemptive relief for a particular type of transaction so many times that the staff determines it would be appropriate to make such relief available to all funds with substantially similar facts, subject to similar conditions. This may be accomplished by the SEC's adoption of an exemptive rule, essentially "codifying" the relief, subject to strict conditions, thereby permitting a particular limited type of transaction that previously would have required individual exemptive orders.11 8 15 U.S.C. §80a-6(c). 9 Protecting Investors, supra note 7, at 503-504 and n. 5 (1992)(quoting Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 197 (1940)). 10 17 C.F.R. 200.30-5(a)(1). 11 See, e.g., Rule 18f-3 under the Investment Company Act, permitting open-end funds to issue multiple classes of voting stock, subject to certain conditions; see also Rules 12d1-2 and 12d1-3 under the Investment Company Act, permitting funds to invest in the securities of other funds beyond the limits established by Section 12(d)(1) of the Investment Company Act, subject to certain conditions. Mr. Gary Barnett September 16, 2013 Page 5 Alternatively, in certain limited situations where the SEC has issued multiple exemptive orders over many years that have "consistently imposed a standard set of conditions to the transaction(s) at issue," the staff may instead grant no-action relief.12 Pursuant to such relief, the SEC staff will agree not to recommend enforcement action provided that an entity adheres to certain representations set forth in the no-action letter; such representations will typically mirror the standard conditions established in the prior exemptive orders. As the staff has explained, adhering to the terms of a no-action letter in these limited circumstances "conserves the resources of both applicants and the staff which would otherwise be expended in the exemptive process."13 Exemptions Under Rule 17d-1 for Activities That May Implicate Regulation 4.20(c) As noted above, Rule 17d-1 permits funds to seek exemptive relief from the SEC for joint transactions that would otherwise be prohibited by the rule. In reviewing such applications, the SEC is required to consider whether the participation of the registered fund "is consistent with the provisions, policies and purposes of the [Investment Company] Act and the extent to which such participation is on a basis different from or less advantageous than that of other participants." The SEC (or, under delegated authority, its staff) considers very carefully the facts of the particular transaction and conditions that may be imposed to address the potential concerns under Section 17(d), and has granted relief for certain arrangements. Based on our review of the relief the SEC and its staff have granted under Section 17(d) and Rule 17d-1 and as discussed in more detail below, it appears that there is only one type of arrangement for which the SEC and its staff have granted relief that potentially may implicate CFTC Regulation 4.20(c). This arrangement is discussed in detail below. Specifically, the SEC has granted over 50 individual exemptive orders, and eventually a no-action letter,14 permitting funds to invest in joint accounts with affiliated funds or other accounts for the limited purpose of making short-term investments. Such accounts have typically been used for the investment of cash collateral such as that received from securities lending activities, or for uninvested cash balances remaining at the end of the day. As the SEC noted, these joint arrangements provide the 12 See, e.g., The Chase Manhattan Bank, SEC No-Action Letter under Investment Company Act Section 17(d), July 24, 2001, available at http://www.sec.gov/divisions/investment/noaction/chase072401.htm ("Chase Manhattan"); see also Signature Financial Group, SEC No-Action Letter under Investment Company Act Section 17(a), December 28, 1999, available at http://www.sec.gov/divisions/investment/noaction/1999/signaturefinancial122899.pdf; Investment Company Institute, SEC No-Action Letter Under Investment Company Act Sections 13(a)(3), 17(a), and 17(d), May 14, 1998, available at http://www.sec.gov/divisions/investment/noaction/1998/deferredcompensationplans051498 .pdf. 13 Id. 14 See Chase Manhattan, supra note 12 (describing a number of these exemptive orders, and granting no-action relief to other funds that engage in similar transactions conducted in accordance with the conditions that were imposed by the SEC in such orders). benefits of saving transaction and other fees, providing better pricing, and offering greater flexibility than any individual fund could obtain on its own.15 The orders permitting joint accounts typically impose a series of approximately 15 conditions designed to address the underlying purposes of Section 17(d) and Rule 17d-1 to "ensure fair dealing and no overreaching in connection with joint transactions involving an investment company and its affiliated persons."16 The conditions include, but are not limited to: (1) The joint accounts will be subject to the participants' custody agreements, and will not be distinguishable from any other accounts maintained by the participants at the custodian except that monies deposited by participants will be held on a commingled basis; (2) Assets in the joint accounts may only be invested in certain specified types of short-term investments, and will be valued on an amortized cost basis to the extent permitted by SEC rules, or staff releases, rules, letters or orders. Short-term investments with remaining maturities of more than seven days will be considered illiquid and investment in such instruments are limited; (3) To prevent any participant from using funds credited to another participant, no participant will be allowed to create a negative balance in a joint account. Each participant will be permitted to draw down its entire balance at any time, provided that the investment adviser determines that such draw-down would have no significant adverse impact on other participants in the joint account. No participant will be obligated to invest in a joint account or maintain a minimum balance in a joint account; (4) The fund's investment adviser will administer the joint accounts as part of its general duties under its advisory or sub-advisory agreements and will not collect any additional or separate fees for doing so;17 (5) Administration of the joint accounts will be within the fidelity bond coverage required by the Investment Company Act;18 (6) The board of trustees or directors of each fund will adopt procedures pursuant to which the joint accounts will operate, which are reasonably designed to provide that the required 15 See, e.g., In the Matter of Fidelity Fund, Inc., et al., Investment Company Act Release Nos. 11962 (notice) (Sept. 29, 1981) and 12061 (order) (Nov. 27, 1981). 16 Id. 17 An investment adviser to a fund has a fiduciary duty to act in the best interests of each fund that participates in the joint account arrangement. 18 See discussion of the requirements of Section 17(g) of the Investment Company Act, supra. Mr. Gary Barnett September 16, 2013 Page 7 conditions are met. The board will determine at least annually that the accounts have been operated in accordance with the procedures, and will permit a fund to continue to participate only if it determines that there is a reasonable likelihood that the fund and its shareholders will benefit from the fund's continued participation; (7) Each participant will participate in a joint account on the same basis as any other participant; (8) Any short-term investments made through a joint account will satisfy the investment criteria of all of the participants; (9) Each participant's investment in a joint account will be documented daily on its books and on the books of its custodian. The records must document, for any given day, the participant's aggregate investment in a joint account and the participant's pro rata share of each short-term investment made through the joint account. Such records must be maintained in conformity with Section 31 of the Investment Company Act and rules thereunder. Any participant that is not a fund, and any investment adviser that is not registered under the Investment Advisers Act of 1940 that advises a participant that is not a fund, will make available to the Commission, upon request, the books and records with respect to such participant's participation in the joint accounts. (10) Short-term investments held in a joint account generally will not be sold prior to maturity unless certain specified conditions relating to the riskiness of the investment are met. The investment adviser or custodian may sell a short-term instrument on behalf of some or all participants prior to the maturity of the instrument, provided that the cost of such transaction will be allocated solely to the selling participants and the transaction will not adversely affect the other participants in the joint account.19 Disclosure and Board Oversight As demonstrated above, the SEC has imposed stringent conditions, and its staff has requested strict representations, in permitting funds to invest in joint accounts with affiliated funds or other accounts for the limited purpose of making short-term investments. These conditions and representations generally have not included disclosure of the arrangement to shareholders, most likely because the fund's board of directors or trustees, including the independent directors or trustees,20 is 19 These conditions are summarized in Chase Manhattan, supra note 12. The conditions included in exemptive orders issued prior to the SEC staff's issuance of Chase Manhattan are consistent with, but may vary in minor respect from, the conditions included in Chase Manhattan. 20 Under the Investment Company Act, a fund board is effectively required to have a majority of independent directors. As the Supreme Court has noted, a fund's independent directors serve as "watchdogs" who furnish an independent check upon the management of the fund. Burks v. Lasker, 441 U.S. 471 (1979). Mr. Gary Barnett September 16, 2013 Page 8 responsible for ensuring that the joint accounts are operated in accordance with the required conditions and in the continued interests of the fund and its shareholders.21 In addition, the SEC has instructed registrants to avoid ". . . including [in their prospectuses] lengthy legal and technical discussions; simply restating legal or regulatory requirements to which Funds generally are subject; and disproportionately emphasizing possible investments or activities of the Fund that are not a significant part of the Fund's investment operations."22 For these reasons, and given the additional protections discussed below, we believe the CFTC staff should defer to the SEC's determination that disclosure to fund shareholders is not necessary under these circumstances. Request for Relief Taken together, we believe the protections under the Investment Company Act and its rules against self-dealing and overreaching, and the conditions imposed by the SEC's exemptive orders and representations included in its no-action relief for limited-purpose joint accounts adequately address the concerns underlying CFTC Regulation 4.20(c). Specifically, the critical oversight role performed by the fund's board under the Investment Company Act and under the conditions and representations described above, the stringent custody rules and required documentation, the prohibition on any participant in such an account creating a negative balance, the requirement that any draw-down must be determined to not have a significant adverse impact on other participants, and the requirement that any investment in such an account must satisfy the investment criteria of all of the participants, all work together to ensure that the interests of fund shareholders are protected from abuse by the CPO. Moreover, such arrangements are desirable precisely to benefit shareholders, because they "facilitate the 'bulk purchase' of Short-Term Investments so that the Participants [can] earn a higher rate on investments, decrease transaction costs, and experience administrative efficiencies."23 We therefore request, consistent with the substituted compliance approach recently taken by the CFTC in its final harmonization rules, that the CFTC staff confirm that funds engaging in such arrangements pursuant to the conditions and representations established by the SEC and its staff, including any further amendments to such relief, related staff no-action or interpretive letters, or codification of this type of relief in an SEC rule, will be deemed not to implicate CFTC Regulation 4.20(c). Additionally, while this letter describes arrangements or transactions that potentially may implicate Regulation 4.20(c) for which the SEC and its staff have granted relief, in the future funds or their advisers may apply to the SEC for Section 17 relief for other types of arrangements or transactions that may implicate Regulation 4.20(c). We recognize that the CFTC staff may desire the opportunity 21 See Condition 6, supra. 22 See General Instructions to Form N-1A (General Instruction C.1(c)). 23 See Chase Manhattan, supra note 12. Mr. Gary Barnett September 16, 2013 Page 9 to consider whether such arrangements or transactions raise concerns under Regulation 4.20(c). We therefore recommend that the CFTC staff request that a fund CPO provide notice to the CFTC staff of any exemptive application under Section 17 and Rule 17d-1 for activities that may directly implicate Regulation 4.20(c), at the time the SEC publishes notice of the application. * * * * We sincerely appreciate the willingness of CFTC staff to address the industry's concerns. 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 Karrie McMillan General Counsel CC: Amanda Olear, Special Counsel Michael Ehrstein, Attorney-Advisor Division of Swap Dealer and Intermediary Oversight Commodity Futures Trading Commission Daniel A. Driscoll, Executive Vice President, Chief Operating Officer Thomas W. Sexton, III, Senior Vice President, General Counsel and Secretary National Futures Association Norm Champ, Director Susan Nash, Associate Director Doug Scheidt, Chief Counsel Division of Investment Management Securities and Exchange Commission