

COMMENT LETTER

October 18, 2010

ICI Letter On NFA Petition To Narrow CFTC Rule 4.5 Exclusion For REGISTERED Investment Companies (pdf)

October 18, 2010 Mr. David A. Stawick Secretary Commodity Futures Trading Commission
Three Lafayette Centre 1155 21st Street, NW Washington, DC 20581 Re: CFTC Request for
Comment Regarding NFA Petition to Amend Rule 4.5 Dear Mr. Stawick: I am writing on
behalf of the Investment Company Institute* to express our deep concerns with a petition
for rulemaking that has been filed by the National Futures Association (“NFA”).¹ The
petition calls upon the Commodity Futures Trading Commission (“CFTC”) to amend Rule 4.5
under the Commodity Exchange Act, which excludes certain “otherwise regulated persons,”
including registered investment companies, from the definition of “commodity pool
operator.” Specifically, the NFA asks that the scope of the Rule 4.5 exclusion be narrowed
significantly—but only for registered investment companies, and not for operators of other
collective investment vehicles that may rely on the rule. The proposed changes to Rule 4.5
could impose overlapping and possibly conflicting regulatory requirements on registered
investment companies, whose shareholders would likely have to bear the associated costs.
The detrimental effect this proposal would have on registered investment companies is
potentially heightened by implementation of the Dodd-Frank Wall Street Reform and
Consumer Protection Act (“Dodd-Frank Act”), to the extent that swaps could potentially be
covered by Rule 4.5. Finally, the NFA fails to justify its request for disparate regulatory
treatment of registered investment companies from other regulated entities that are able
to rely on Rule 4.5. * 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 \$11.51
trillion and serve over 90 million shareholders. 1 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). Mr. David Stawick October 18, 2010
Page 2 of 8 Background The term “commodity pool operator” (“CPO”) is broadly defined in
the Commodity Exchange Act to include any person engaged in a business that is of the
nature of an investment trust, syndicate, or other form of enterprise, and who, in
connection therewith, solicits, accepts or receives from others, funds, securities, or property
. . . for the purpose of trading in any commodity for future delivery on or subject to the
rules of any contract market² Rule 4.5 permits specified persons that are regulated
under other federal laws and/or state law to operate certain collective investment vehicles,
or so-called “qualifying entities,” without becoming subject to CFTC and NFA regulation as a

CPO. Qualifying entities include registered investment companies, insurance company separate accounts, bank trust and custodial accounts, and retirement plans subject to ERISA fiduciary rules. To rely on this exclusion, the person must file a notice of eligibility with the NFA representing that the qualifying entity will disclose in writing to its existing and prospective customers/investors that it is operated by a person not subject to registration as a CPO. Rule 4.5 in its present form has been in place since August 2003. Prior to that time, the rule required registered investment companies and other qualifying entities to comply with restrictions regarding positions in commodity futures or commodity option contracts held for non-bona fide hedging purposes ("Non-Hedging Restriction") and the marketing of participations to the public ("Marketing Restriction" and, together with the Non-Hedging Restriction, the "Pre-2003 Restrictions"). In 2002, the CFTC published an advance notice of proposed rulemaking to address certain market developments and changed circumstances for persons not excluded or exempt from regulation as a CPO or commodity trading advisor. According to the 2002 notice: [Prior to 1979], there were fewer than a dozen designated commodity interest contracts based on stock indices, interest rates or other financial instruments. Since 1979, however, the Commission has designated, and trading has commenced in, more than 180 commodity interest contracts based on various financial instruments. These contracts frequently have attracted the interest of operators of collective investment vehicles, some of whom have registered with the Commission as CPOs so that they can use commodity interest contracts in their investment and risk management strategies. Others, however, have avoided participation in the commodity interest markets. While [CFTC] Rules 4.5 2 Section 1a(5) of the Commodity Exchange Act. The Dodd-Frank Act expands the definition of CPO to include the trading of swaps. The new definition appears in Section 1a(11) of the Commodity Exchange Act. Mr. David Stawick October 18, 2010 Page 3 of 8 and 4.13 do provide CPO registration relief, their criteria are too restrictive for many operators of collective investment vehicles to meet.³ After considering comments filed in response to the 2002 notice, receiving additional feedback through its September 2002 Roundtable on CPO and CTA Issues, and performing its own analysis, the CFTC proposed to eliminate the Non-Hedging Restriction, concluding that "otherwise regulated" persons and qualifying entities "may not need to be subject to any commodity interest trading criteria to qualify for relief under Rule 4.5."⁴ This proposal was part of a broader package of amendments to various CFTC rules that, taken together, were intended to allow greater flexibility and innovation, and to take into account market developments and the current investment environment, by modernizing the requirements for determining who should be excluded from the CPO definition, and who should remain within the CPO and CTA definitions but be exempt from registration. Thus, this relief is intended to encourage and facilitate participation in the commodity interest markets by additional collective investment vehicles and their advisers, with the added benefit to all market participants of increased liquidity.⁵ In its proposing release, the agency also requested comment on the merits of retaining the Marketing Restriction in Rule 4.5. Most commenters expressed strong support for eliminating both Pre-2003 Restrictions, which the CFTC determined to do in adopting the 2003 amendments to Rule 4.5. Potential for Overlapping and Possibly Conflicting Regulatory Requirements on Registered Investment Companies The NFA petition identifies three registered investment companies and raises objections with regard to each investment company's use of a wholly-owned subsidiary to engage in a limited amount of futures trading (i.e., no more than 25% of its investment portfolio, as disclosed in the investment company's registration statement and as specifically permitted by the Internal Revenue Service ("IRS")). Yet the revisions to Rule 4.5 sought by the NFA would impact not just registered investment companies utilizing this structure, but potentially all registered investment companies that provide

³ See Commodity Pool Operators and Commodity Trading Advisors; Exemption From Requirement

To Register for CPOs of Certain Pools and CTAs Advising Such Pools, 67 Fed. Reg. 68785, 68786 (Nov. 13, 2002). 4 See Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors, 68 Fed. Reg. 12622, 12626 (March 17, 2003). 5 See *id.* at 12625. In this regard, 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. Mr. David Stawick October 18, 2010 Page 4 of 8 their shareholders with some degree of exposure to commodity futures or commodity options markets as part of a diversified, securities-based investment portfolio. For example, the revisions would relate to registered investment companies that trade futures and options whether they provide exposure to the performance of physical commodities (e.g., crude oil) or securities (e.g., S&P 500 futures and interest rate futures). The NFA describes its proposed amendments to Rule 4.5 as an effort to “restore operating restrictions on registered investment companies that are substantially similar to those in effect prior to 2003.” In fact, the restrictions outlined in the petition are much broader in scope than the Pre-2003 Restrictions—and, if adopted, would result in a much more limited exclusion under Rule 4.5 for registered investment companies than existed prior to 2003. As discussed more fully below, we do not believe the NFA petition presents a compelling case that any modification of Rule 4.5 is necessary at this time. Although the NFA petition appears to relate solely to commodity futures and options, we note that the Dodd-Frank Act expands the definition of “commodity pool operator” to include the trading of swaps. ICI and its members would strenuously oppose any efforts to include swaps in the types of instruments to be covered under a revised Rule 4.5. Many registered investment companies, including fixed-income funds, use interest rate and total return swaps as part of their principal investment strategies. Adopting the restrictions set forth in the petition, and then applying those restrictions to swaps, could have severe negative consequences for a broad range of registered investment companies.

Non-Hedging Restriction The NFA proposes to reinstate the Non-Hedging Restriction, and to broaden it so that any positions in commodity futures or commodity option contracts for non-hedging purposes would need to be held “by a qualifying entity only.” This new language would effectively preclude a registered investment company from using the subsidiary structure discussed above. The NFA suggests that such a result is appropriate because the subsidiary is unregulated and thus poses harm to investors. These assertions reflect a misunderstanding about the regulations applied to these investment vehicles. The subsidiary structure is used by registered investment companies for tax purposes and not to evade regulation under the Investment Company Act of 1940 (“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.⁶ Direct 6 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. Mr. David Stawick October 18, 2010 Page 5 of 8 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.

The IRS private letter rulings described above specifically require the subsidiaries to comply with Section 18 of the Investment Company Act and all associated guidance from the Securities and Exchange Commission ("SEC") regarding coverage and the use of leverage by registered investment companies. In addition, it is our understanding that the staff of the SEC's Division of Investment Management requires registered investment companies employing a subsidiary structure to operate the subsidiary in conformity with the key substantive provisions of the Investment Company Act, notably Section 8 (investment policies), Section 17 (affiliated transactions and custody requirements) and Section 18 (capital structure and leverage).⁷ It is also important to note that the financial statements of the subsidiary are either included in the registered investment company's annual and semi-annual reports to shareholders or consolidated with the financial statements of the registered investment company. More broadly, the NFA has failed to demonstrate why a return to the five percent non-hedging limit would be appropriate. Such a showing is of critical importance, because the NFA is effectively asking the CFTC to reverse its conclusion—which, as described above, was the product of a very extensive public comment and rulemaking process—that the five percent limit was too restrictive.⁸ ⁷ In addition, the subsidiary is wholly owned by its respective registered investment company and is ultimately under the control of the registered investment company, as its sole shareholder. The subsidiary cannot take any extraordinary action without the approval of the registered investment company and its board of directors, which in most cases would have at least 75% independent directors. ⁸ Even registered investment companies whose commodity futures and options positions are just a small part of their investment portfolios would have to establish additional monitoring and compliance controls to ensure that their non-hedging positions would stay below the proposed five percent limit. It should also be noted that the Dodd-Frank Act requires the CFTC to more narrowly define which transactions will be considered to be for bona fide hedging purposes, which could potentially increase the types of transactions that would need to fit within the five percent limit. Mr. David Stawick October 18, 2010 Page 6 of 8 Marketing Restriction The NFA petition also proposes to reinstate the Marketing Restriction, and to broaden it so that Rule 4.5 would be unavailable to any registered investment company that markets its shares as participations in a vehicle otherwise seeking investment exposure to the commodity futures or commodity options markets. The petition fails to explain why the NFA believes this new language is necessary or to give any indication as to its intended scope. ICI and its members are concerned that this new language could be interpreted broadly, even applying to registered investment companies whose investment portfolios (whether directly or indirectly through a so-called "fund-of-funds" structure) have only a modest exposure to commodity futures and options.⁹ The proposed language is also broad enough that it could apply to an investment company's use of commodity futures or options for bona fide hedging purposes or within the stated five percent non-hedging limit, thereby rendering the exceptions within the NFA's proposal effectively moot. Finally, as drafted, the provision could encompass basic prospectus disclosure concerning the range of investments the investment company may be entitled to make. Unnecessary to Impose Additional Layer of Regulation The restrictions outlined in the NFA petition would sharply curtail the ability of registered investment companies to rely on Rule 4.5. Instead, investment companies would be forced to choose between equally problematic outcomes: overlapping and possibly conflicting regulation by the SEC and the CFTC, two separate federal regulators with very different approaches to regulation, or limited use of commodity futures and options positions, which would limit their ability to provide retail investors with exposure to an important asset class (i.e., commodities) and to use futures to provide exposure to securities indices and interest rates.¹⁰ It bears emphasizing that the choice between these two outcomes is precisely what the CFTC was seeking to eliminate through its 2003 rule

amendments. Investment companies are already extensively regulated under the Investment Company Act and other federal securities laws, as the NFA petition acknowledges. The protections afforded under the securities laws include, among others: limits on the use of leverage; antifraud provisions; 9 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 in other investment companies whose portfolios include investments in non-traditional asset classes such as commodities and commodities-related products. 10 Financial advisers today, following modern portfolio theory, encourage clients to diversify across a broad range of asset classes; the range of potential investments includes stocks, bonds and commodities. For investors with a smaller amount of assets to invest, registered investment companies provide an effective (and cost-effective) means to diversify their investment portfolios. Mr. David Stawick October 18, 2010 Page 7 of 8 comprehensive disclosure to investors, including with regard to fees and expenses, the investment objectives 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; and restrictions on transactions with affiliates. Importantly, this regulatory scheme 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 subject to regulation under the Investment Advisers Act of 1940 and related SEC rules, which also include antifraud protections. The CFTC's 2003 amendments rightly acknowledged that registered investment companies do not need to be subject to the full weight of CFTC and NFA regulation and oversight. The NFA petition fails to present a compelling case that a different conclusion is now warranted. Failure to Justify Disparate Treatment for Registered Investment Companies The NFA's original petition for rulemaking, filed with the CFTC in June, sought to narrow the Rule 4.5 exclusion for all "otherwise regulated persons" to which the rule now applies. Two months later, the NFA withdrew that petition and filed the version published for comment, which seeks changes to Rule 4.5 that would apply only to registered investment companies. The NFA asks that the full range of CFTC and NFA rules and oversight be imposed on any registered investment company offered to retail investors that engages in "more than a de minimis amount of futures trading."11 As noted above, such a step could have a chilling effect on the ability of registered investment companies to offer exposure to commodity futures or commodity options markets, at a time when greater diversity of investment opportunities is a priority for average investors seeking to minimize investment risk yet still grow their investments. There does not appear to be any rationalization for imposing additional regulation and oversight on registered investment companies that are already highly regulated, whereas other qualifying entities offered to retail investors (or, in the case of bank trust and custodial accounts, operated to their benefit) would continue to be subject to a single alternate regulatory scheme. The NFA petition provides no justification in support of the disparate regulatory treatment that it proposes. Request for Meeting The changes outlined in the NFA petition, if adopted by the CFTC, would represent a drastic turnaround from the agency's decision in 2003 to broaden participation by collective investment vehicles in the commodities markets. We thus respectfully request that the CFTC give full and careful 11 Although much of the discussion in the NFA's petition centers on retail investors, the changes that the NFA is proposing to Rule 4.5 would apply to all registered investment companies, regardless of their shareholder base. Mr. David Stawick October 18, 2010 Page 8 of 8 consideration to all issues raised by the petition and not move forward with any rulemaking to amend Rule 4.5 until the concerns outlined in our letter have been resolved.

In that regard, ICI would appreciate the opportunity to meet with appropriate members of the agency's staff to discuss our concerns regarding the NFA petition and its potential impact on registered investment companies. ***** ICI appreciates the CFTC's attention to our comments. If you have any questions, please contact me at 202/326-5815 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 Kevin P. Walek, Assistant Director Daniel S. Konar II, Attorney-Adviser Division of Clearing and Intermediary Oversight

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