October 18, 2010

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

Re: National Futures Association Petition to Amend Commission Rule 4.5

Dear Mr. Stawick:

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**" or the "**Commission**") with our comments regarding the petition of the National Futures Association (the "**NFA**") to amend the Commission Rule 4.5 exclusion of registered investment companies from the definition of "commodity pool operator" (the "**Petition**").[2]

The AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. Many AMG member firms sponsor or advise investment companies registered under the Investment Company Act of 1940 (the "**Investment Company Act**"). These registered investment companies may invest in commodity futures and options as part of their respective investment strategies.

In the Petition, the NFA has requested that the CFTC restore and expand the exclusion's pre-2003 requirements, pursuant to which a registered investment company claiming the exclusion was required to represent that it (i) will use commodity futures or options contracts solely for hedging purposes or, in cases of non-hedging purposes, limit the aggregate initial margin and premiums on such positions to five percent of the liquidation value of the investment company's portfolio (net of all unrealized profits and losses) (the "**5% Limit**") and (ii) will not be marketed to the public as a commodity pool

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] The NFA's August 18, 2010 petition (the "**NFA Petition**"), which amended a petition initially submitted in June by the NFA, can be found at http://www.nfa.futures.org/news/newsPetition.asp?ArticleID=3630.

or a vehicle for trading in commodity futures or options contracts (the "**Marketing Restriction**").[3] For the reasons discussed below, the AMG believes that the NFA's proposed amendments to Commission Rule 4.5, if adopted, would subject registered investment companies to duplicative and in some cases inconsistent regulatory regimes, have a broader than intended restrictive impact on a registered investment company's ability to pursue its investment strategies, and impose significant regulatory burdens and costs without a corresponding benefit to investors, the futures markets or the general public. The AMG therefore urges the CFTC to decline to adopt the NFA's proposed amendments to Commission Rule 4.5.

Registered investment companies are already highly regulated, and regulation as a commodity pool operator (a "CPO") would impose duplicative and in many cases inconsistent regulatory requirements.

The AMG believes that the NFA's proposals will not result in increased customer protections, but will instead subject registered investment companies to duplicative, and in many cases inconsistent, regulatory requirements. Registered investment companies are already subject to robust regulatory requirements and oversight by federal regulators. Under the Investment Company Act regime, registered investment companies are required to comply with extensive disclosure, custody, recordkeeping, reporting and other compliance requirements that, in general, are no less stringent than the CFTC's requirements for registered CPOs. For example, a registered investment company is already subject to extensive requirements to disclose material information to investors (in its Prospectus, Statement of Additional Information and other disclosure documents) under the Investment Company Act and other federal securities laws, including material risks and potential conflicts of interest,[4] and must comply with recordkeeping, reporting and other requirements, including anti-fraud provisions,[5] that are similar to CFTC

[3] The NFA Petition, like the pre-2003 conditions previously instituted by the CFTC, appears to relate only to the investment in or trading of "commodity futures or commodity options contracts" by registered investment companies. The AMG believes that "swaps" and "securities futures products" should not implicate the 5% Limit or the Marketing Restriction, notwithstanding the expanded definitions of "commodity pool" and "commodity pool operator" under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). *See* Commodity Exchange Act ("**CEA**") § 1a(11) as amended by the Dodd-Frank Act. This comment letter relates solely to the NFA's proposed rule change as it relates to commodity futures and options.

[4] Under the requirements of Form N-1A, registered investment companies are required to disclose the fundamental characteristics and investment risks of the fund, including detailed disclosure of fees and expenses, principal investing risks and financial highlights, all in accordance with specific disclosure instructions. Form N-1A requires conflicts-related disclosure including portfolio holdings information, management of fund investments by portfolio managers and payments to broker-dealers and other financial intermediaries. Although Form N-1A does not appear on its face to require conflicts disclosure that is equivalent to Part 4 of the CFTC regulations, the Investment Company Act requires built-in conflicts reduction mechanisms within the investment company structure not required of CPOs under CFTC regulations. For example, the Investment Company Act requires mutual funds to have a majority of independent board of directors, imposes heavy restrictions against transactions with affiliates and requires advisers to registered investment companies to be registered themselves under the U.S. Investment Advisers Act of 1940 (the "**Advisers Act**"), which subjects advisers to additional requirements relating to conflicts of interest, including disclosure requirements. *See, e.g.,* Investment Company Act Release No. 24816 (Jan. 2, 2001), available at http://www.sec.gov/rules/final/34-43786.htm; Investment Company Act § 17; Advisers Act § 203A; Form ADV Part II.

[5] In its Petition, the NFA argues that the marketing of registered investment companies as commodity pools necessitates the applicability of the anti-fraud provisions of Section 4o of the CEA, which (…continued)

regulations.[6] In its August 2003 decision to eliminate the 5% Limit and the Marketing Restriction from Commission Rule 4.5, the CFTC agreed that the "otherwise regulated nature" of the qualifying entities, including registered investment companies, specified in Commission Rule 4.5 would provide adequate customer protection.[7] The NFA also agreed in its comment letter to the 2003 Proposed Rule that the elimination of the 5% Limit would "reduce participant costs—thereby increasing participant returns—by eliminating the costs of duplicative regulation…."[8]

To the extent that the NFA's proposal would impose additional requirements on registered investment companies to which they are not already subject, registered investment companies would be subject to potentially inconsistent regulations. For example, the NFA argues in its Petition that the offering materials of registered investment companies do not include "performance information for. . . other funds operated by the investment adviser" as would otherwise be required by Part 4 of the CFTC Regulations.[9] However, the inclusion of related performance information in any sales material published or distributed in respect of a mutual fund by a broker-dealer that

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(continued…)

do not apply to qualifying entities relying on the Commission Rule 4.5 exclusion (including qualifying entities other than registered investment companies who engage in the same marketing practices). *See* NFA Petition, *supra* note 2; NFA Comment Letter to the Proposed Rule Release (May 1, 2003), available at http://www.cftc.gov/files/foia/comment03/foicf0306c018.pdf (the "**NFA Comment Letter**"). However, registered investment companies are already subject to stringent anti-fraud provisions under the federal securities laws. Notably, Section 4o of the CEA is a general anti-fraud provision patterned closely to the anti-fraud provisions of the federal securities laws to which registered investment companies and their investment advisers are subject. *Cf.* Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934; Section 17(a)(3) of the Securities Act of 1933 (the "**Securities Act**"); Section 206 of the Advisers Act. Courts have generally looked to the federal securities laws for interpretative guidance on the applicability of Section 4o. *See, e.g.,* CTFC v. Savage, 611 F.2d 270 (9th Cir. 1979).

[6] For example, a registered CPO must furnish monthly or quarterly statements of account to each investor. *See* CFTC Regulations 4.22(a) and (b). Similarly, under the Investment Company Act, registered investment companies are required to furnish semi-annual and annual financial statements to shareholders, as well as to file quarterly, semi-annual and annual reports with the SEC, which are publicly available to investors. *See* Investment Company Act § 30; Rule 30e-1 under the Investment Company Act. As another example, CFTC regulations prohibit a CPO from advertising in a deceptive manner, using testimonials or presenting hypothetical performance data without a prescribed accompanying statement. *See* CFTC Regulation 4.41. Similarly, the Advisers Act subjects advisers to registered investment companies to anti-fraud requirements relating to, among other things, advertising and use of performance information. *See, e.g.,* Advisers Act § 206(4); Rule 206(4)-1 under the Advisers Act; Clover Capital Mgmt., Inc., SEC No-Action Letter (Oct. 28, 1986). The Securities Act also subjects investment companies to advertising requirements. *See, e.g.,* Rule 482 of the Securities Act. As a further example, a registered CPO must make and keep certain books and records. *See* CFTC Regulation 4.23. Similarly, the Investment Company Act requires registered investment companies to maintain books and records, generally for at least six years. *See, e.g.,* Rules 31a-1, 31a-2 and 31a-3 under the Investment Company Act.

[7] *See* Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues, CFTC Final Rule Release, 68 Fed. Reg. 47221 (Aug. 8, 2003), available at http://www.cftc.gov/foia/fedreg03/foi030808a.htm (the "**Final Rule Release**"); Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors, CFTC Proposed Rule Release, 68 Fed. Reg. 12622 (Mar. 17, 2003), available at http://www.cftc.gov/foia/fedreg03/foi030317b.htm (the "**Proposed Rule Release**").

[8] NFA Comment Letter, *supra* note 5.

[9] *See* NFA Petition, *supra* note 2.

is a member of the Financial Industry Regulatory Authority ("**FINRA**") is prohibited under NASD Rule 2210.[10] The AMG believes that these and other inconsistencies create needless and burdensome compliance issues for mutual funds seeking to provide commodities exposure to their investors as part of an investment program.

The NFA's proposal would impose regulatory burdens and costs on registered investment companies without a corresponding benefit to investors, the futures markets or the general public.

The NFA's proposal would result in higher costs and regulatory burdens on registered investment companies, including the duplicative costs of registering with both the SEC and the CFTC and attendant reporting, disclosure, recordkeeping and other requirements. Each "associated person" of a registered CPO would additionally be required to register with the NFA and become subject to proficiency examinations and other requirements.[11] These additional costs may become so prohibitive for some registered investment companies that such funds may stop trading commodity futures and options altogether, or severely limit their use of these strategies, thereby limiting retail investors' exposure to commodities as an asset class, reducing the liquidity of futures and options markets[12] and restricting efficient fund management strategies.

The AMG believes that the NFA's proposal could also create a disruptive change to existing registered investment company operations. The CFTC eliminated the 5% Limit and the Marketing Restriction in 2003, and in the intervening seven years mutual funds have developed their investment strategies accordingly. Restoring these conditions could lead to significant disruptions, with little perceived benefit, in the practices of firms that utilize these strategies.

The amendments to Commission Rule 4.5 as proposed by the NFA may have a broader than intended restrictive impact on a registered investment company's investment objectives and policies.

The Marketing Restriction. The AMG believes that the Marketing Restriction proposed by the NFA is so broad on its face that registered investment companies that utilize futures and options may not be able to satisfy such restriction given their disclosure obligations to investors under the federal securities laws. The Marketing Restriction requires a registered investment company claiming the exclusion to represent that it will not be marketed to the public as a commodity pool or "a vehicle for trading in *(or otherwise seeking investment exposure in)* the commodity futures or commodity

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[10] *See* NASD Rule 2210; FINRA Interpretive Letter to Michael D. Udoff, Securities Industry Association (Oct. 2, 2003), available at: http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P002534.

[11] *See, e.g.,* CFTC Regulation 3.12.

[12] The CFTC stated in its Final Rule Release that liquidity of the futures and options markets was an important factor in its decision to eliminate the 5% Limit and Marketing Restriction. *See* Final Rule Release, *supra* note 7 ("[T]his 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.").

options markets" (emphasis added).[13] The Marketing Restriction would thus reinstate the pre-2003 Marketing Restriction that was eliminated by the CFTC in 2003, and further add "(or otherwise seeking investment exposure in)" to the text of the pre-2003 condition.[14]

The Marketing Restriction could prevent registered investment companies that provide adequate disclosure on their use of commodity futures and options from relying on the Commission Rule 4.5 exclusion, even if otherwise within the prescribed 5% limits suggested by clause (a) of the proposed addition to Rule 4.5. Under a literal reading of the restriction, a registered investment company providing any amount of commodity futures or options exposure would be subject to registration as a CPO for any oral, written or electronic statements to the public that it is a vehicle trading in or providing investment exposure to commodities. Even such a registered investment company trading commodity futures or options within the 5% Limit could nevertheless be required to register as a CPO, essentially eviscerating the 5% Limit. The AMG believes that the broad language of the Marketing Restriction engenders significant regulatory uncertainty and imposes restrictions on registered investment companies beyond the scope of what is intended. As noted by a 2003 commenter, the potential result of the Marketing Restriction is a severe "prophylactic effect on the participation in the commodity interest markets by otherwise regulated institutional investors".[15] In light of such unintended effects and the "otherwise regulated nature" of registered investment companies, the AMG believes that the Marketing Restriction is unnecessary and overly expansive in reach. We respectfully note that the CFTC appeared to have reached the same conclusion in 2003. In its August 2003 decision to eliminate the Marketing Restriction from Commission Rule 4.5, the CFTC agreed that "[c]ompliance with the subjective nature of the marketing restriction could give rise to the possibility of unequal enforcement…."[16]

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[13] *See* NFA Petition, *supra* note 2.

[14] Prior to the 2003 changes, the Marketing Restriction required that a registered investment company relying on the Rule 4.5 exclusion represent that it "[w]ill not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures or commodity options markets." 17 C.F.R. § 4.5 (2003).

[15] Katten Muchin Zavis Rosenman comment letter to the Proposed Rule Release (May 1, 2003), available at http://www.cftc.gov/files/foia/comment03/foicf0306c029.pdf.

[16] *See* Final Rule Release, *supra* note 7. Although the CFTC stated in its adoption of the pre-2003 Marketing Restriction that it would continue to permit "accurate disclosure of the [registered investment company]'s limited use of commodity interests" in sales literature (*see* Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons From the Definition of the Term "Commodity Pool Operator"; Other Regulatory Requirements, CFTC Final Rule Release, 50 FR 15868 (Apr. 23, 1985)), commenters advocating for its elimination in 2003 noted the continued subjective difficulties of interpreting such a broad restriction. *See, e.g.,* Kirkland and Ellis, for General Motors Investment Management Corporation, comment letter to the Proposed Rule Release (May 1, 2003), available at http://www.cftc.gov/files/foia/comment03/foicf0306c023.pdf ("Moreover, retaining the marketing prohibition while deleting the commodity interest limitation will exacerbate the regulatory uncertainty that has always existed with respect to this prohibition…."); Katten Muchin Zavis Rosenman comment letter to the Proposed Rule Release (May 1, 2003), available at http://www.cftc.gov/files/foia/comment03/foicf0306c029.pdf. In eliminating the restriction in 2003, the CFTC appeared to agree with such commenters. *See* Final Rule Release, *supra* note 7.

"Otherwise regulated nature" of registered investment companies. The AMG believes that the NFA has failed to provide in its Petition a clear rationale as to why registered investment companies already subject to federal regulatory oversight should be subject to dual regulatory requirements. In its Petition, the NFA focuses on the "unregulated" nature of mutual funds' use of wholly-owned subsidiaries to invest in commodity futures transactions. According to the NFA, such subsidiaries are neither registered as investment companies nor as CPOs, and therefore fall into a regulatory "loophole" permitting such companies to conduct activities outside of regulatory oversight. Therefore, the NFA believes that "to the extent that the Commission's 2003 amendments to Regulation 4.5 were…premised on the 'otherwise regulated nature' of the qualifying entities, this premise may no longer be valid."[17]

The AMG respectfully disagrees with the NFA's position on this issue. The AMG believes that there has been no evidence of harm to the markets or abuse by registered investment companies (or their subsidiaries) who utilize commodity futures and options in accordance with the current regulatory regime. As the NFA concedes in its Petition, the purpose of the parent-subsidiary structure is tax efficiency, *i.e.,* to "provide the funds with exposure to futures and commodities in a manner consistent with the limitations of the federal tax requirements in Sub-chapter M of the IRS Code."[18] Mutual funds utilizing this parent-subsidiary structure rely on IRS private letter rulings which conclude that income arising from a mutual fund's investment in a subsidiary that invests in commodities investments constitutes qualifying income. These same private letter rulings require such subsidiaries to comply with the requirements of Section 18(f) of the Investment Company Act and all related guidance regarding asset coverage and the use of leverage by mutual funds.[19]

The AMG also disputes the characterization of such subsidiaries as "unregulated." Although the subsidiaries are not separately registered as investment companies, each subsidiary is included within the regulatory limitations applicable to its registered parent. In various SEC No-Action Letters, the SEC has permitted registered investment companies to establish wholly-owned foreign subsidiaries for the purpose of avoiding unfavorable foreign tax treatment or foreign investment restrictions, and has acknowledged that such subsidiaries did not avoid any regulatory requirements[20] since

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[17] *See* NFA Petition, *supra* note 2.

[18] *Id.* Furthermore, the Regulated Investment Company Modernization Act of 2010 ("**RIC Modernization Act**"), passed by the U.S. House of Representatives on September 28, 2010, would expand the definition of qualifying income to include gains from the sale or other disposition of commodities investments by registered investment companies (the "**Qualifying Income Amendment**"), potentially eliminating the need for the parent-subsidiary structure of such funds. *See* H.R.4337 - Regulated Investment Company Modernization Act of 2010, available at http://waysandmeans.house.gov/media/pdf/111/HR4337_Regulated_Investment.pdf.

[19] *See, e.g.,* I.R.S. Priv. Ltr. Rul. 201039002 (June 22, 2010); I.R.S. Priv. Ltr. Rul. 201037012 (June 4, 2010); I.R.S. Priv. Ltr. Rul. 201030004 (Apr. 28, 2010); I.R.S. Priv. Ltr. Rul. 201034011 (Apr. 23, 2010); I.R.S. Priv. Ltr. Rul. 200842014 (July 17, 2008); I.R.S. Priv. Ltr. Rul. 200840039 (June 13, 2008); I.R.S. Priv. Ltr. Rul. 200822010 (Feb. 12, 2008); I.R.S. Priv. Ltr. Rul. 200743005 (July 20, 2007); I.R.S. Priv. Ltr. Rul. 200741004 (July 10, 2007); I.R.S. Priv. Ltr. Rul. 200647017 (Aug. 10, 2006).

[20] Section 48(a) of the Investment Company Act makes it unlawful for a person to do indirectly through another person what would be unlawful to do directly.

the parent-subsidiary structures were operated in accordance with the Investment Company Act.[21]

The AMG believes that these parent-subsidiary investment structures are consistent with the "otherwise regulated nature" of the Commission Rule 4.5 exclusion, and therefore do not evince requiring reinstatement of the 5% Limit and the Marketing Restriction for registered investment companies. In light of these factors, as well as recent legislative policy towards liberalizing the ability of mutual funds to invest in commodities,[22] the AMG urges the CFTC to decline to adopt the NFA's proposed amendments to Commission Rule 4.5.

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The AMG thanks the CFTC for the opportunity to comment on the NFA's proposed amendments to Commission Rule 4.5 and for the CFTC's consideration of the AMG's views. The AMG's members would appreciate the opportunity to further comment on these topics. If you have any questions, please do not hesitate to call either Danforth Townley, Davis Polk & Wardwell LLP, at 212-450-4240 or the undersigned at 212-313-1389.

Sincerely,

Timothy W. Cameron, Esq.
Managing Director, Asset Management Group
Securities Industry and Financial Markets Association

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[21] *See, e.g.,* S. Asia Portfolio, SEC No-Action Letter (Mar. 12, 1997), Templeton Vietnam Opportunities Fund, Inc., SEC No-Action Letter (Sept. 10, 1996), The Spain Fund, Inc., SEC No-Action Letter (Mar. 28, 1988) and The Scandinavia Fund, Inc., SEC No-Action Letter (Nov. 24, 1986). *See also* Fidelity Select Portfolio, SEC No-Action Letter (Apr. 29, 2008), wherein the SEC permitted a registered investment company to consolidate its financial statements with its subsidiary despite the subsidiary's unregistered status. The SEC cited as a basis for its decision the subsidiary's operation "in all other respects as an investment company", that consolidation "would give shareholders a more accurate picture of the [parent] and its financial position, structure and investment strategies" and "the fact that the sole purpose of the [subsidiary] is to serve as a vehicle through which the [parent] gains exposure to particular commodities".

[22] Regarding the Qualifying Income Amendment (see *supra* note 18), the Ways and Means Committee notes in its summary of the RIC Modernization Act that "[f]inancial advisors today encourage clients to diversify across a broad range of asset classes, including commodity investments. This aspect of current law prevents shareholders from accessing commodity investments through mutual funds." *See* H.R. 4337 Regulated Investment Company Modernization Act of 2009, Ways and Means Committee Summary (Dec. 16, 2009), available at http://waysandmeans.house.gov/media/pdf/111/MA_Summary.pdf.