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October 18, 2010

Via e-mail to: NFAamendrule4.5@cftc.cgov

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

Re: National Futures Association Petition to Amend Commission Rule 4.5

Ladies and Gentlemen:

We are writing regarding the petition of the National Futures Association dated August 18, 2010 that requested that the Commission amend its Rule 4.5 as it relates to investment companies registered with the Securities and Exchange Commission under the Investment Company Act of 1940. The petition expressed the NFA's views that certain investment companies may be marketed and operated in a manner contrary to the Commission's expectations after its amendment of Rule 4.5 in 2003.

Overview

Because we believe the basis for the 2003 amendment to the rule remains fully valid and compelling, we respectfully disagree with the NFA's assertion that Rule 4.5 requires amendment at this time. In addition, we respectfully submit that it is appropriate to take a more balanced view of the registered investment company products at issue than did the NFA petition. As a regulated alternative source of capital and liquidity, the contributions of these companies to efficient and orderly markets, within a comprehensive investor protection framework, should continue to be given great weight.

We also recommend that the Commission consider the broader context of a possible reversal of Rule 4.5 at this juncture. As the Commission and other agencies implement a series of new regulatory and market structures mandated under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the perception of a stable underlying regulatory environment will be at a premium.

If, after due consideration of the policy issues presented and comments received, the Commission wishes to proceed with Rule 4.5 rulemaking, we recommend the Commission (a) do so in a measured manner that recognizes differences among structures and strategies used and (b)

consult with the SEC to mitigate the burdens of dual, and potentially conflicting, regulation presented by any change in the operation of Rule 4.5 that might be pursued.

Intervening Events Have Not Changed the Basis for the 2003 Amendments

The Commission amended Rule 4.5 in 2003 principally because it determined that entities relying on Rule 4.5 are "otherwise regulated" and that those alternative regulatory schemes provide appropriate consumer protections without requiring the overlay of substantive trading regulation by the Commission. Those circumstances continue to apply.

2010 has brought no relaxation of the Investment Company Act's requirements or of SEC enforcement, inspection or guidance activity as compared with 2003. The alternative regulatory regime implemented by the SEC is as robust today as previously. Nor, with a significant expansion of resources to be made available to the SEC as a result of the Dodd-Frank Act, are there grounds to foresee such a relaxation in the future.

In particular, we note that the regulatory framework applicable to registered investment companies includes the following:

- Comprehensive SEC regulation deriving from the Securities Act of 1933, Securities Exchange Act of 1934, Investment Advisers Act of 1940, and Investment company Act
- Mandated supervision by a majority-independent board of directors
- Mandated internal compliance policies and procedures, including a requirement that there be a designated chief compliance officer with a confidential reporting line to the board
- Mandated leverage limits (including in respect of the leveraging effects of futures and other derivatives)
- Mandated transparent capital structure
- Mandated shareholder voting rights
- Mandated conflict of interest rules (many conflict of interest of transactions are prohibited, others require board oversight)
- Mandated custody practices under which all assets are held with regulated custodians (most commonly U.S. banks)
- SEC requirements on the content, public filing and timing of prospectuses and annual reports
- SEC and Financial Industry Regulatory Authority advertising requirements, including a FINRA review process for investment company advertising and SEC and FINRA performance presentation rules
- Mandated public quarterly holdings reports
- Mandated public filing of key contracts
- Mandated maintenance of fidelity bonds

- FINRA rules governing compensation paid to intermediaries who sell investment company shares

Certainly during parts of the 2003-2010 period there was significant market upheaval, but we do not believe those events call into question the efficacy of alternative regulation under the Investment Company Act. Aside from events at a very few investment companies that were tied to problems at particular issuers (e.g., Lehman Brothers) or in respect of subprime-related bonds, investment companies largely performed in line with the markets in which they invest. In an outcome attributable to many aspects of the Investment Company Act framework described above, but especially to the Act's strict limits on leverage, there were no investment company bankruptcies. That is so even as many other kinds of investment vehicles were severely buffeted by the markets. In other words, the risk-limiting protections embedded in the Investment Company Act were put to the test, but remained solid.

Focusing on the instruments of most interest to the Commission, current SEC attention to use of derivatives by registered investment companies serves as clear testament that the 2003 amendments' concept of alternative regulation is operating as intended. Examples of the SEC focus on derivatives include:

- A series of public statements by senior SEC officials encouraging investment companies to consider the risks of their use of derivatives and their disclosures of these risks and announcing a related SEC staff initiative to undertake a broad review of the use of derivatives by registered investment companies.[1]
- An in-depth study of derivatives regulation under the Investment Company Act that the SEC's Division of Investment Management requested from a committee of the American Bar Association and that was delivered to the SEC staff earlier this year.[2]
- An open letter to the investment company industry from the office responsible for disclosure review in the SEC's Division of Investment Management identifying ways in which funds can improve the usefulness of their derivatives-related disclosures.[3]

Also relevant is the role of independent investment company boards. These boards are closely involved in overseeing use of derivatives by investment companies, and their involvement

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1 *See, e.g., SEC Staff Evaluating the Use of Derivatives by Funds*, SEC Press Release 2010-45 (March 10, 2010), *available at* http://www.sec.gov/news/press/2010/2010-45.htm; Remarks by SEC Division of Investment Management Director Andrew J. Donohue before the Practicing Law Institute (April 8, 2010), *available at* http://www.sec.gov/news/speech/2010/spch040810ajd.htm; Remarks by SEC Division of Investment Management Director Andrew J. Donohue before the American Bar Association (April 17, 2009), *available at* http://www.sec.gov/news/speech/2009/spch041709ajd.htm.

2 *Report of the Task Force on Investment Company use of Derivatives and Leverage*, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010), *available at* http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf.

3 Letter to Investment Company Institute from Barry D. Miller, Associate Director, Office of Legal and Disclosure, SEC Division of Investment Management (July 30, 2010), *available at* http://www.sec.gov/divisions/investment/guidance/ici073010.pdf.

increased markedly as market volatility increased.[4] That is exactly what one would expect given the role of these independent boards, recognized by the SEC and the federal courts as "watchdogs" under the Investment Company Act[5], and is further evidence of the strength of the Act's alternative regulatory framework.

A More Balanced View of the Registered Investment Company Products at Issue Would Be Appropriate

For all of the theoretical concerns raised, we understand that perhaps the most significant tangible effect to date of the registered investment companies at issue has been the added presence in the commodity markets of a highly regulated source of liquidity. The NFA's proposed amendments, if adopted, would strike a blow to the precise sort of innovation and increased participation and liquidity in the regulated commodity markets that (a) the Commission, in announcing its proposed amendments to Rule 4.5 in 2003, declared were "consistent with the purpose and intent of the CFMA...."[6], and (b) the activities of these registered investment companies would seem to exemplify. The contributions of these companies to efficient and orderly markets should be recognized and considered as a counterweight to the negative views of these companies set out in the NFA petition.

We also note that the NFA petition focuses on the existence of subsidiary companies formed by certain registered investment companies and asserts that these subsidiaries are not subject to the Investment Company Act. However, the subsidiaries are broadly, albeit indirectly, subject to regulation under that Act. First, using a controlled subsidiary structure to evade core investment company protections such as leverage limits, asset custody, affiliated transaction rules, and SEC books-and-records access could implicate the provision of the Act (Section 48(a)) that prohibits doing indirectly what one cannot do directly under the Act. In our experience, both the companies that form these subsidiaries, and the SEC staff in reviewing their operations, recognize and respect the resulting regulatory overlay. Second, any material subsidiary is required to be described in detail in the prospectus and/or financial reports of the registered investment company that owns it, assuring public transparency of the structure and the opportunity for SEC risk and other disclosure review. Third, independent public accountants take account of such a subsidiary in preparing financial statements for a registered investment company and do so in a manner that effectively applies public company accounting rules to these subsidiaries. Finally, such a subsidiary is subject to the oversight of the registered investment company's independent directors, who, in accord with their significant fiduciary obligations, attend closely to the operations of the subsidiary.

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4 *See, e.g., As SEC Raises Derivatives Concerns, Boards Step Up Overight*, Beagan Wilcox, BoardIQ (April 3, 2007); *Use of Chief Risk Officers on the Rise*, Whitney Kvasager, BoardIQ (Oct. 5, 2010).

5 *See, e.g., Jones v. Harris Associates L.P.*, 559 U.S. __ (2010).

6 68 Fed.Regist. 12622, 12625.

The Broader Regulatory Context Should Be Considered

The NFA's proposed amendments would add substantial burdens and seem capable of undermining regulatory credibility at a time when the Commission and other agencies are tasked with an unprecedented volume of required rulemaking. Put plainly, we are concerned that major market participants will be less willing to commit substantial resources to entering the regulated commodity markets in the future if in doing so they perceive the possibility of uncertain rulemaking. Given the obvious importance of market confidence in the variety of new structures that will have to accompany the new rules, this is not, in our view, a concern to take lightly.

Seen in that light, it should be impossible to ignore the unintended consequences of the "exemptive rug" potentially being pulled out from under the registered investment company industry. After all, the industry developed and invested in these innovative products in reasonable expectation that the policy justifications underlying the Commission's 2003 Rule 4.5 amendments were solid.

Any Actions Taken Should Focus on Specific Concerns and Should Recognize Different Structures and Strategies

Marketing

The NFA petition appears to focus on concerns about marketing. A number of our points above demonstrate the significant extent to which alternative regulation under the Investment Company Act applies to marketing as well (for example, the SEC's investment company industry letter cited above focuses on derivatives disclosure). If the Commission nonetheless ultimately determines that those specific concerns warrant revisiting the 2003 amendments, it should be possible to do so in a measured way.

In particular, if the Commission is most persuaded with respect to the NFA position with respect to marketing, then only the petition's proposed limitations on marketing – and not the proposed numeric investment limit – would seem appropriate. As further described below, we believe that the proposed numeric investment limit is a much more intrusive regulatory response. We recommend that such a limit not be mandated absent concerns tied directly to management of a fund's investment program.

We also note that we agree with the comments to the earlier 2003 rulemaking that the proposed marketing limitations require explanation of a type that will allow firms to thoughtfully structure their operations in a manner that comports with Commission expectations. Any marketing limitation that may be under consideration therefore should not be implemented without adequate accompanying interpretive guidance from the Commission. Moreover, because the scope and content of any Commission guidance will be key to the efficacy of the relevant limitation, any guidance from the Commission should first be proposed, subject to public comment, before being finalized.

Fund Structures

The NFA petition appears to focus on a particular investment company structure involving the formation and operation by an investment company of a controlled subsidiary that trades futures. In this regard, our points above regarding alternative regulation apply regardless of structure, so that we again encourage the Commission to consider carefully whether the circumstances before it warrant revisiting the 2003 rulemaking and, if so, whether the full battery of proposals in the NFA petition are needed.

In the first instance, we observe that the limited and specific nature of the NFA's concerns may not warrant formal rulemaking. Assuming the Commission agrees with those concerns, it instead should be possible to achieve the Commission's regulatory goals through interpretive guidance and statements of concern limited to the particular structure involved. Alternatively, if the Commission is inclined to consider the NFA petition's proposed limitations on marketing, those limitations may render any structure-related concerns moot.

We especially recommend care if the Commission is inclined to go further and consider the NFA petition's proposed numeric investment limit. Limitations on particular investments or investment strategies go to the core of a registered investment company's business. Therefore, and given the overlay of alternative regulation (which, again, includes leverage rules that already limit exposure to futures and other derivatives), the level of intrusion represented by this type of numeric limit should be assessed relative to the particular concerns identified. Should the Commission wish to reconsider the pre-2003 (or any other) numeric limit on the investment programs of registered investment companies, these considerations strongly suggest that cooperation with the SEC in doing so will be appropriate.

We also note that exposure to futures through a separate vehicle can come in many different forms. For example, many investment companies will invest in one or several underlying unregistered funds as a substitute for direct investment, and those underlying funds may use futures. A common instance of this would be an investment company that finds certain international markets best approached, for tax or other reasons, through a fund that is dedicated to and structured for the particular market. If a registered investment company's indirect exposure to futures through such an underlying fund were to "count" against any new Rule 4.5 numeric limit, that could foreclose this investment strategy altogether, at least when the underlying fund is independent of the registered investment company. The ability to comply with such a "look-through" limit presupposes that the registered investment company can control the futures trading by the underlying fund, which will not always be the case.

Another example of indirect exposure is in the area of registered investment companies following a "fund of hedge funds" strategy, i.e., investing in a diverse pool of underlying hedge funds managed by portfolio managers independent of the registered investment company. These investment companies face the same issues as those just described, but to an even more pointed degree, given that their investment strategy is investment in underlying funds. For the same reasons outlined above (principally the inability to control an independent underlying fund), if

indirect exposure to futures through such an underlying fund were to "count" against a Rule 4.5 numeric limit, that could foreclose this investment strategy altogether.

In short, we are concerned that if the Commission ultimately determines that such a numeric investment limit is appropriate, it may inadvertently act without regard to the variety of strategies and structures being used in the marketplace. As already illustrated as one area of concern, the application of any "look-through" of a limit to investment vehicles underlying a registered investment company would appear in many instances to be unnecessarily complex relative to the incremental additional protections gained.

Cooperation With the SEC Should Be Part of Any Approach Undertaken in this Area

Finally, if the Commission wishes to consider rulemaking that will affect registered investment companies, especially in as targeted a manner as here, cooperation with the SEC is appropriate. Options that would minimize dual regulatory burdens should be considered, and aspects of the two regulatory regimes that may be inconsistent with each would deserve special attention. We respectfully recommend that such cooperation precede any formal rulemaking.

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We appreciate the opportunity to comment on the NFA petition and respectfully request that the Commission consider the comments and recommendations set forth above. We are available to discuss these comments and recommendations should the Commission or the staff so desire. Our partners Nathan Greene at 212-848-4668 or ngreene@shearman.com and Paul Schreiber at 212-848-8920 or pschreiber@shearman.com would be happy to do so.

As a final note, our comments and recommendations represent the views of the partners of the firm named above and should not be ascribed to any current or former client of Shearman & Sterling LLP.

Respectfully submitted,

Shearman & Sterling LLP/NJG

Shearman & Sterling LLP

Please arrange copies to:

Hon. Gary Gensler, Chairman
Hon. Bart Chilton, Commissioner
Hon. Michael Dunn, Commissioner
Hon. Scott. D. O'Malia, Commissioner
Hon. Jill E. Sommers, Commissioner