Morgan, Lewis & Bockius LLP
1111 Pennsylvania Avenue, NW
Washington, DC 20004
Tel: 202.739.3000
Fax: 202.739.3001
www.morganlewis.com

Morgan Lewis
COUNSELORS AT LAW

W. John McGuire
Partner
202.739.5654
wjmcguire@morganlewis.com

October 18, 2010

David A. Stawick
Secretary, Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581
VIA E-mail
(NFAamendrule4.5@cftc.gov)

Re: National Futures Association Petition to Amend Commission Rule 4.5

Dear Mr. Stawick:

On behalf of Rydex SGI, we appreciate the opportunity to comment on National Futures Association's ("NFA") Petition to the Commodity Futures Trading Commission (the "Commission" or "CFTC") to amend CFTC Rule 4.5 ("NFA Petition"). Rydex SGI is an investment management firm that has been registered with Securities and Exchange Commission ("SEC") as an investment adviser since February 10, 1993. Rydex SGI sponsors more than 100 mutual funds and exchange-traded products and manages more that $17 billion in customer assets.

We support NFA's goal to ensure that retail investors are protected through appropriate regulation of vehicles in which they invest. For the reasons discussed below, however, we do not believe that the petitioned for amendments to CFTC Rule 4.5 are necessary or appropriate to achieve this goal.

I. Background of Rule 4.5

Briefly stated, section 1a(5) of the Commodity Exchange Act (the "Act") defines a commodity pool operator ("CPO") as "[a]ny person engaged in a business that is of the nature of an investment trust, syndicate, or similar 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 . . . except that the term does not include such persons not within the intent of the definition of the term as the Commission may specify by rule,

regulation, or order." Rule 4.5 was first adopted by the Commission in April 1985 in response to a directive by the Senate Committee on Agriculture, Nutrition, and Forestry (the "Committee") to provide relief from regulation as a commodity pool operator ("CPO") for certain otherwise regulated entities that are not intended to be included within the definition of a CPO.[1]

Rule 4.5, as initially adopted, provided an exclusion from the definition of CPO for certain eligible persons operating certain qualified entities, including an investment company registered under the Investment Company Act of 1940 (the "Investment Company Act"). The Rule required that the eligible person be able to represent that with regard to its operation of the qualified entity: (i) the commodity interests would be traded "solely for bona fide hedging purposes" consistent with CFTC Rule 1.3(z)(1) or long positions that were accompanied by a cash set-aside (ii) that the aggregate initial margin and premiums for commodity interests would be no more than 5% of the fair market value of the investment company's assets; (iii) that the entity would not be marketed as a commodity pool or as a vehicle for trading in commodity interests; and (iv) that written disclosure of the purpose and limitations on the scope of the commodity interest trading being engaged in would be provided to each prospective participant.[2]

As the Commission gained experience in the administration of Rule 4.5, it amended the rule to, among other things, simplify the rule by eliminating the cash set-aside test and reduce the limitation on trading commodity interest to permit unlimited bona fide hedging and non-hedging positions, so long as the aggregate initial margin or premium required to establish such positions did not exceed 5% of the liquidation value of the investment company's portfolio, commonly referred to as the "5% Test."[3] In October 2002, the Commission proposed to amend Rule 4.5 to provide an alternative to the 5% Test. Specifically, the proposal would have permitted a qualifying entity to invest in commodity interests, so long as the aggregate notional value of such positions did not exceed the liquidation value of the entity's portfolio.[4]

In November 2002, the Commission issued an advance notice of proposed rulemaking in which it sought comment on further proposals to expand exclusions from regulation as a CPO and commodity trading advisor ("CTA"). In the advanced notice of proposed rulemaking the

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1 *Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Pool Operator"; Other Regulatory Requirements*, 50 FR 15868 at 15868 - 15869 (April 23, 1985) (*citing* S. Rep. No. 384, 97th Cong., 2d Sess. 80 (1982)).

2 *Id.* at 15882-15883.

3 *Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons from the Definition of the term "Commodity Pool Operator"*, 58 FR 6371 (Jan. 28, 1993).

4 *Exclusion for Certain Otherwise Regulated Persons From the Definition of the Term "Commodity Pool Operator,"* 67 FR 65743 (Oct. 28, 2002).

Commission noted that the criteria for registration relief under Rule 4.5 and Rule 4.13 were "too restrictive for many operators of collective investment vehicles to meet."[5]

The Commission followed the October 2002 proposal and the advanced notice of proposed rulemaking with a proposal to expand existing registration relief for certain CPOs and CTAs, including the relief provided for under Rule 4.5.[6] The Commission stated that the proposed amendments 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] 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.[7]

The Commission explained that futures margins had historically been set at levels such that the 5% Test had permitted the notional value of non-hedging commodity interests to approximate the liquidation value of the qualifying entity's portfolio. Margin levels for certain securities index futures contracts, however, had begun to exceed five percent of the value of the contracts and, thus, the use of such contracts in non-hedging strategies was limited under the 5% Test.[8] The Commission further noted that it was proposing to provide additional exemptions from CPO registration "based *solely* on pool participant sophistication" regardless of whether the pool operator was subject to another regulatory scheme and since the eligible persons under Rule 4.5 were regulated the Commission believed "that, like the unregulated CPOs for whom it is proposing relief . . . these persons and entities may not need to be subject to any commodity interest trading criteria to qualify for relief."[9] Accordingly, the Commission proposed to eliminate as conditions to eligibility under Rule 4.5 any limitations on the amount of trading in commodity interests and the related disclosure requirement.

In August 2003, the Commission adopted amendments to Rule 4.5 eliminating the trading restrictions, related disclosure requirement, and the prohibition against the qualifying entity

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5 *Commodity Pool Operators and Commodity Trading Advisors; Exemption From Requirement To Register for CPOs of Certain Pools and CTAs Advising Such Pools*, 67 FR 68785 (Nov. 13, 2002).

6 *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors*, 68 FR 12622 (March 17, 2003).

7 *Id.* at 12625.

8 *Id.*

9 *Id.* at 12625 - 12626 (emphasis in original) (Proposed Rule 4.13(a)(4) proposed to exempt from CPO registration operators of pools where the participants were sophisticated investors).

being marketed as a commodity pool or otherwise as a vehicle to trade commodity interests. Instead, the Commission imposed a requirement that the eligible person claiming relief under Rule 4.5 disclose in writing to each participant in the qualifying entity that the claimant is relying on the exclusion from the definition of CPO and, thus, is not subject to registration or regulation under the Act (the "2003 Amendments").[10] In adopting the amendments, the Commission stated that it had eliminated the marketing limitation under Rule 4.5 in response to comments it received that "the 'otherwise regulated' nature of the qualifying entities specified in Rule 4.5 would provide adequate customer protection."[11]

NFA's petition, if adopted, would essentially re-impose on registered investment companies the 5% Test and the prohibition on marketing that the Commission has previously determined unnecessary.

II. The Reasons the 2003 Amendments Continue to be Relevant Today

Since the adoption of the 2003 Amendments, the regulation of investment companies by federal regulators has only become more extensive. For example, in December 2003 the SEC adopted new rules under the Investment Company Act and the Investment Advisers Act of 1940 that require each investment company and investment adviser registered with the SEC to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering the policies and procedures.

More recently, in the wake of the financial turmoil of 2008, the SEC has committed itself "to close regulatory gaps, strengthen[] shareholder rights, and improv[e] the quality of disclosures provided to investors."[12] Other market regulators to which investment companies are subject have embarked on equally committed campaigns to strengthen their respective regulatory regimes, including the Financial Industry Regulatory Authority ("FINRA") and the vast majority of exchanges. The reasons cited by the Commission in support of expanding the availability of the Rule 4.5 exclusion, the otherwise regulated nature of investment companies and the related customer protections already in place, have only become more pronounced since the adoption of the 2003 Amendments.

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[10] *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues*, 68 FR 47221 (Aug. 8, 2003).

[11] *Id.*, at 47223 - 47224.

[12] U.S. Securities and Exchange Commission 2009 Performance and Accountability Report (November 16, 2009).

Investment companies are subject to extensive disclosure, recordkeeping and reporting requirements analogous to, and in some cases broader than, those required of CPOs. A registered investment company must file with the SEC a registration statement that consists of (i) a prospectus, (ii) a statement of additional information ("SAI"), and (iii) related exhibits, including the investment company's organizational documents and all material contracts related to its investment activities. The prospectus and SAI are required to include the investment strategy of the investment company, including a description of the instruments in which it will invest and the related risks. Registration statements, as well as any material changes, must be reviewed by the SEC staff and are publicly available through the SEC website. An investment company must provide a shareholder with a copy of the prospectus, or summary prospectus,[13] no later than at the time the shares of the fund are purchased. Additionally, existing shareholders typically receive any material changes to the prospectus throughout the year, and a new prospectus annually.[14]

In addition to the registration statement, the Investment Company Act requires that registered investment companies prepare and disseminate semi-annual and audited annual financial reports and prepare on a quarterly basis a schedule of the investment company's portfolio holdings. These reports are filed with the SEC and available for anyone to view through the SEC's website. In addition to the Investment Company Act, registered investment companies that sell their shares in a public offering must also register the shares of the investment company with the SEC pursuant to the Securities Act of 1933 ("1933 Act").

Further, the sales practice requirements of the Securities Exchange Act of 1934 and FINRA regulations apply to the broker-dealer acting as the investment company's distributor. Accordingly, all marketing material related to the sale of the investment company's shares must be reviewed and approved by FINRA prior to being disseminated by the distributor.
In proposing the 2003 Amendments, the Commission noted the increase in commodity interest contracts based on financial instruments and the resulting increase in interest by collective interest vehicles to utilize these commodity interest contracts.[15] The Commission further recognized the need to modernize its regulations to permit "greater flexibility and innovation, and to take into account market developments" and to "encourage and facilitate participation in the commodity interest markets by collective investment vehicles . . . with the added benefit to

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13 The SEC permits investment companies to satisfy their prospectus delivery requirement by providing shareholders with a detailed summary prospectus, coupled with full web access to the fund's statutory prospectus, and any changes thereto.

14 Although not specifically required to provide existing shareholders with updates to the prospectus after the time of purchase, industry practice generally, and the practice at Rydex specifically, is to provide all existing shareholders with all material changes to the prospectus throughout the year and a new prospectus annually.

15 68 FR 12622 at 12624 (quoting the advanced Notice or Proposed Rulemaking 67 FR 68785, 68786).

all market participants of increased liquidity."[16] Since the adoption of the 2003 Amendments, the commodities market has continued to evolve and grow at an impressive rate all the while generating new and innovative investment opportunities.[17] Perhaps more now than ever before the commodities market is attractive to collective investment vehicles responsible for managing the funds of millions of retail investors who are seeking ways to diversify their investment holdings to better weather volatile times in the financial markets.

III. Use of a Subsidiaries to Gain Exposure to the Commodities Market

In its petition, NFA referenced the fact that registered investment companies may in some circumstances use wholly-owned and controlled subsidiaries to gain exposure to the commodities market. NFA noted that these subsidiaries are not themselves registered investment companies. While it is true that these subsidiaries are not registered investment companies, they should not be thought of as operating wholly outside of regulatory requirements.

Mutual fund complexes have established controlled foreign corporations ("CFCs") formed as wholly-owned subsidiaries of a registered investment company in response to a determination by the Internal Revenue Service ("IRS") that income produced from trading in derivatives, including commodity interests, is not "good income" under Section 851(b)(2) of the Internal Revenue Code (the "Code") and, thus, registered investment companies investing directly in such instruments jeopardize their ability to qualify as regulated investments companies ("RICs") under Subchapter M of the Code.[18]

The IRS subsequently issued several private letter rulings ("PLRs") in which it ruled that the distributions received from a wholly-owned subsidiary organized as a CFC would constitute dividends and therefore "good income" under Section 851(b)(2) of the Code, notwithstanding the fact that the CFC invested directly in commodities and commodity interests. The relief granted in the PLRs requires that three conditions be satisfied: (1) each CFC must be incorporated as an exempted limited company under the laws of the country in which it is organized; (2) each CFC must comply with the requirements of Section 18(f) of the Investment Company Act, Investment Company Act Release No. 10666 and related SEC guidance pertaining to asset coverage as to transactions in commodity-linked financial instruments and other derivatives transactions; and

[16] *Id.* at 12625.

[17] In 2003 global trading volume in futures and options was less than 9 billion contracts, by 2009 global trading had surpassed 17 billion contracts. *Trading Volume Statistics*, Futures Industry Website (viewed on October 11, 2010) (http://www.futuresindustry.org/volume-.asp).

[18] Briefly stated, if the investment company does not qualify as a RIC, the income of the investment company will be taxed twice, once at the fund level and then again as dividends distributed to its shareholders. Accordingly, it is paramount to the operation of all mutual funds that they qualify as RICs under Subchapter M.

(3) in compliance with the RIC diversification rules, the registered investment company's investment in the CFC may not exceed 25% of the registered investment company's total assets.

The effect of these conditions is that the registered investment company, as the sole shareholder of the CFC, will never be at risk for an amount greater than its investment in the CFC, which is limited to 25 percent of the registered investment company's assets. Thus, the investment risk borne by a shareholder of the registered investment company remains limited to the amount the shareholder invested in the registered investment company. The fact that the registered investment company has investment exposure to the CFC's investments in futures and options contracts does not increase the risk of loss borne by the shareholder. The application to the CFC of Section 18(f), Investment Company Act Release No. 10666 and related SEC guidance limits the CFC's ability to incur leverage. Specifically, the CFC, unlike regulated public commodity pools, must limit its investments in derivatives to an amount that it can cover with its remaining assets. Moreover, by the terms of the PLRs and the limited liability structure of the CFC, the CFC is not permitted to rely on the assets of its registered investment company shareholder to cover its investments in derivatives.

The existence of the CFC and its financial operations and investment activities are transparent to the shareholders of the registered investment company. The investment in the CFC constitutes a component of the registered investment company's principal investment strategy and is, therefore, required to be disclosed in the registered investment company's prospectus and statement of additional information, including a description of the attendant risks of such investment.[19] Additionally, a registered investment company must disclose the expense of investing in a CFC in the prospectus and file consolidated financial statements that detail the financials of both the registered investment company's portfolio and that of the CFC, including a consolidated schedule of investments and a consolidated statement of assets and liabilities.[20]

Finally, as discussed above, a registered investment company's board of directors, which is typically composed of a majority of independent directors,[21] is responsible for overseeing the management and operations of registered investment companies on behalf of the shareholders and has a fiduciary obligation to act in the registered investment companies' best interests.[22] A

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[19] Item 4, Form N-1A.

[20] Regulation S-X § 3A-02.

[21] Section 10(a) of the Investment Company Act requires that at least 40% of a board of directors be composed of independent directors. In practice, however, most investment company's have a majority of independent directors.

[22] State law governing the organizational form of the investment company, *i.e.*, a Delaware statutory trust, generally imposes on directors and trustees traditional fiduciary responsibilities, including the duties of care and loyalty. In addition, Section 36(a) of the Investment Company Act provides that trustees and directors may be held liable for any breach of fiduciary duty involving personal misconduct. See also *Burks v. Lasker*,

registered investment company's board of directors is responsible for approving, among other things, the investment in the subsidiary. The board of directors may also determine at any time that it is not in the best interest of the registered investment company to continue its investment in the subsidiary. Accordingly, investment company boards of directors routinely request and review information about the subsidiary's investment activities, operations, expenses, and performance.

Additionally, as NFA acknowledges in its Petition, a number of the mutual fund complexes that operate such subsidiaries have also required that they comply with the registered investment company's investment policies and procedures, including any applicable fundamental and non-fundamental investment restrictions. This further ensures that the subsidiary's interests are completely aligned with those of the investment company.

IV. The Pre-2003 Limitations under Rule 4.5 Should not be Re-Imposed

As discussed above, we believe that the regulated nature of registered investment companies and their related activities and the customer protections provided by such regulations make amending Rule 4.5 unnecessary. If the Commission, nonetheless, decides to move forward with proposing amendments to limit the exclusion under Rule 4.5, we respectfully suggest that the Commission consider, and request comments on, several important issues and not simply re-impose the pre-2003 limitations as petitioned for by NFA.

A. The Commission should solicit comment as to whether the 5% Test is appropriate.

As the Commission noted in adopting the 2003 Amendments to Rule 4.5, while the 5% Test traditionally permitted the notional value of non-hedging commodity interests positions to approximate the liquidation value of the qualifying entity's portfolio, certain margin levels for stock index futures are such that the use of such contracts would be limited under the 5% Test. The Commission should request comments for possible alternatives to the 5% Test.

B. The Commission should provide guidance regarding any marketing prohibitions.

As originally adopted, Rule 4.5 prohibited marketing participations in the qualifying entity "as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures or

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441 U.S. 471, 484 (1978) citing *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (1977) and Hearings on H.R. 10065 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess., 109 (1940) (One of the purposes of the Investment Company Act structure is to "place unaffiliated directors in the role of 'independent watchdogs,' who would 'furnish an independent check upon the management' of investment companies.").

commodity options markets."[23] NFA's Petition, however, includes marketing it as a vehicle "otherwise seeking investment exposure to" the commodity futures or commodity options markets. This language could suggest that marketing an investment company that seeks exposure to commodity interests through instruments not subject to the Commission's jurisdiction, such as structured notes, could subject the investment company to regulation as a CPO. We recommend that if marketing prohibitions are adopted, they should be narrowly tailored to only prevent soliciting investments in products clearly subject to the Commission's jurisdiction. We also encourage the Commission to augment its guidance concerning what constitutes marketing subject to the restriction. For example, does the use of the term "commodity" in a registered investment company's name constitute the type of marketing intended to be restricted by the representation. As discussed previously, Form N-1A requires that registered investment companies disclose their principal investment objectives, strategies, investment types, and risks. Would such disclosures be considered marketing in prohibition of the rule?

C. Harmonization of CFTC and SEC conflicting regulations.

If the Commission determines to limit the exclusion under Rule 4.5, certain investment companies will now be subject to regulation by both the SEC and the CFTC. To the extent that SEC and CFTC regulations are in conflict, the Commission should work with investment companies to ensure that additional regulatory burdens are not imposed without providing meaningful additional protections for customers. For example, registered investment companies are required to provide annual and semi-annual reports and generally provide quarterly financial statements to shareholders, whereas CPOs must provide monthly statements. Due to the widely held nature and extensive trading of open-end investment company shares, it would be prohibitively expensive for an investment company to ascertain its shareholders and provide them with account statements every month. Moreover, Rydex SGI ensures that shareholders can access their relevant account information, including the net asset value of their account holdings, via its website at anytime.

In addition to regulatory differences, the structure of most registered investment companies do not lend themselves to the existing regulatory scheme for commodity pools. In the case of a registered investment company, it is not clear which entities or persons would be required to register as a CPO. A registered investment company's investment adviser, principal underwriter, and board of directors could each arguably be deemed to be the CPO.[24] The Commission will

[23] 50 FR 15868 at 15883.

[24] The Commission has provided that a CPO is generally the person promoting the pool, who will have authority to hire and fire the pools investment adviser and to elect the pool's futures commission merchant. 49 Fed. Reg. 4778 (Feb. 8, 1984). *See also, CFTC v. Heritage Capital Advisory Services, Ltd.*, (ND ILL. Nov. 8, 1982)['82-'84 Transfer Binder], Comm. Fut. L. Rep. (CCH) ¶ 21,627 (Company was a CPO where it had control to pool the funds, even though it did not have ultimate control over the investment decisions of the pool); CFTC

need to provide additional guidance as to which entities or persons would be expected to register as a CPO. As discussed previously, the role of a registered investment company's board of directors as fiduciaries for the investment company and its shareholders is central to the protections under the Investment Company Act. Requiring independent directors to take on additional regulatory duties and liabilities by becoming registered as CPOs could have a chilling effect on the willingness of qualified individuals to serve as a director of a registered investment company.

As evidenced by the history of Rule 4.5, the Commission has consistently shown a willingness to continue to develop its regulations in response to changing market conditions. Additionally, in the context of exchange traded products ("ETPs") the Commission has recognized that strict compliance with Commission regulations are unnecessary where substituted compliance can continue to meet the fundamental purpose of the regulation. Operators of ETPs have consistently obtained relief from disclosure and reporting requirements where the required information is readily available to investors on a publicly available web site.[25] The Commission has also provided relief from registering as a CPO for certain independent directors and trustees of actively managed ETPs.[26] If the Commission determines to adopt amendments to Rule 4.5 we urge it to also consider providing comparable relief for investment companies.

V. Conclusion

For the reasons discussed above, we believe that limiting the exclusion under Rule 4.5, as petitioned for by NFA, is unnecessary to protect customers participating in investment companies. If the Commission, however, determines that amendments to Rule 4.5 are required,

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Interpretative Letter No. 75-17 ['75-'77 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,112 (Nov. 4, 1975) (CPO definition includes any person "that *handles or exercises control over*" the assets of persons investing in a commodity pool. Even though an investment company that did not solicit funds for purposes of trading commodity futures, but subsequently was authorized to engage in such trading, it is a CPO. Additionally, if the investment advisors for such funds handle or exercise control over the assets of the funds would also be required to register as CPOs).

[25] *See* CFTC Staff Letters 10-24 [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 31,586 (Jun. 28, 2010); 10-23 [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 31,584 (Jun. 7, 2010); 10-22 [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 31,583 (Jun. 3, 2010); and 08-16 [2007-2009 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,925 (Sep. 3, 2008). *See also Commodity Pool Operators: Relief From Compliance With Certain Disclosure, Reporting and Recordkeeping Requirements for Registered CPOs of Commodity Pools Listed for Trading on a National Securities Exchange; CPO Registration Exemption for Certain Independent Directors or Trustees of These Commodity Pools*, 75 FR 54794 (Sept. 9, 2010)(proposing to codify relief from certain disclosure, reporting and recordkeeping requirements has previously provided for on a case-by-case basis in CFTC Staff letters).

[26] *See* CFTC Staff Letter 10-06 [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 31,557 (Mar. 29, 2010).

it should take into account the highly regulated nature of investment companies and where appropriate provide relief from Commission requirements.

We would be happy to discuss any of the issues raised in this letter with Commission staff. Please feel free to contact me at 202-739-5654 or at wjmcguire@morganlewis.com.

Sincerely,

W. John McGuire

cc: Chairman Gary Gensler
Commissioner Michael Dunn
Commissioner Bart Chilton
Commissioner Jill E. Sommers
Commissioner Scott O'Malia
Ananda Radhakrishnan
Kevin Walek