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April 12, 2011

By Electronic Mail

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

Dear Mr. Stawick:

Re: RIN number 3038–AD30 - CFTC Request for Comment Regarding Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (76 Fed. Reg. 7976)

This letter presents the comments of Federated Investors, Inc. and its subsidiaries ("Federated") in response to the recent proposal by Commodity Futures Trading Commission (the "Commission" or "CFTC") to amend CFTC Rule 4.5. Federated appreciates the opportunity to register its comments and hopes that the CFTC finds them useful. Additionally, Federated would like to express its general support for the comments made by the Investment Company Institute in its letter of April 12, 2011.

Federated is one of the largest investment management firms in the United States, managing approximately $358.2 billion in assets as of December 31, 2010. With 136 mutual funds and various separately managed accounts, Federated provides comprehensive investment management services worldwide to approximately 5,000 investment professionals and institutions.

SUMMARY

The CFTC has recently proposed amendments to its Rule 4.5 that, if adopted, could substantially affect the use of derivatives by registered investment companies. Underlying Rule 4.5 is a policy that the CFTC does not need to regulate mutual funds, since the funds are already regulated by the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940 (the "1940 Act"). The proposed amendments to Rule 4.5 would impose additional restrictions on the use of futures and swaps by registered investment companies. These restrictions include, as further defined below (1) a Hedging Restriction, (2) a 5% Test for positions that do not qualify for the Hedging Exemption, and (3) a problematic Marketing Restriction.

In summary, Federated believes that:

(1) The proposal to adopt the Hedging Restriction and the 5% Test ignores a long history of industry and regulatory concerns with the application of the bona fide hedging definition to the use of financial futures by institutional investors. If adopted as proposed, the amendments may expose mutual fund shareholders to less efficient portfolio management and, by extension, increased risks. Simply stated, Federated believes that the concept of bona fide hedging should not be reintroduced to Rule 4.5. However, if the concept of bona fide hedging will be included in the amended rule, Federated urges the CFTC to expand the Rule 4.5 exemption from CPO regulation to treat risk management positions taken by registered investment companies similarly to the treatment of bona fide hedge positions.

(2) The Marketing Restriction may directly conflict with the SEC's disclosure mandates in respect to a mutual fund's use of derivatives. Federated believes that this is one illustration of the concern that if Rule 4.5 is expanded as proposed, otherwise regulated institutions will be subject to duplicative and conflicting regulatory structures. Federated also believes that this requirement is unnecessary as the SEC and the Financial Industry Regulatory Authority ("FINRA") regulate the marketing and distribution of a registered investment company's shares.

(3) The proposed rules also restrict the ability of registered investment companies from "otherwise seeking investment exposure to" derivatives, which, in turn, jeopardizes a common structure utilized by mutual fund complexes like Federated whereby one mutual fund invests in another mutual fund. Federated believes the "otherwise seeking investment exposure" language is not necessary and should not be included in the Marketing Restrictions. However, if such language is adopted, then the CFTC should clarify that the aforementioned structure will not be implicated by the amended rule.

As a final introductory matter, Federated objects to any application of restrictions under Rule 4.5 to over-the-counter derivatives (broadly defined as "swaps" under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")), since this particular segment of the derivatives markets is in the midst of an overhaul of such enormous scale and scope so as to render it impossible for the mutual fund industry to analyze the effect of the proposed amendments to Rule 4.5 on a mutual fund's use of swaps.

Accordingly, Federated believes that the Hedging Restriction, 5% Test and Marketing Restriction should not be adopted, as proposed. Additionally, Federated believes that the CFTC should undertake – with the assistance of the entire mutual fund industry – a comprehensive study that analyzes the use of derivatives by registered investment companies and the possible effects of the proposed rule on the industry and the broader economy.

<u>COMMODITY EXCHANGE ACT – RELEVANT PROVISIONS</u>

Section 4m(1) of the Commodity Exchange Act the ("CEA") makes it unlawful for any person to engage in business as a commodity pool operator ("CPO") without being registered with the CFTC as such.

Generally, a CPO is defined as the individual(s) or entity that has oversight responsibility with respect to a collective investment vehicle that invests in commodity futures and options contracts.[1]

CFTC RULE 4.5 – CURRENT VERSION OF THE RULE

CFTC Rule 4.5 provides for the exclusion of certain otherwise regulated persons from the CPO definition, including any investment company registered as such with the SEC under the 1940 Act (a "registered investment company" or "mutual fund").

Specifically, CFTC Rule 4.5 excludes the operator of a registered investment company[2] from regulation and registration as a "commodity pool operator," so long as three conditions are met:

1. the mutual fund's registration statement contains disclosure to the effect that the fund's operator has claimed the exclusion and is not subject to registration and regulation as a CPO;

2. the mutual fund has filed the required notice with the CFTC (via the National Futures Association or "NFA") to claim the exclusion; and

3. the mutual fund submits to any special calls by the CFTC from time to time.

Underlying Rule 4.5 is a policy that the CFTC does not need to regulate mutual funds, since they are already regulated by the SEC under the 1940 Act.

CFTC RULE 4.5 – FEDERATED'S CONCERNS WITH THE PROPOSED AMENDMENTS

In February 2011, the CFTC proposed amendments to Rule 4.5 that would impose additional restrictions on the use of futures by registered investment companies.[3]

> *A Hedging Restriction; The 5% Test* - The fund will use commodity futures or commodity options contracts, or swaps solely for bona fide hedging purposes; and, with respect to positions that may be held by the fund for non-bona fide hedging purposes, the aggregate initial margin

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[1] The term "commodity pool operator" is defined in Section 1a(5) of the CEA, in pertinent part, as "any person engaged in a business which is of the nature of an investment trust…and who, in connection therewith solicits, accepts or receives from others, funds…either directly or through capital contributions…for the purpose of trading in any commodity for future delivery on or subject to the rules of…" any futures exchange, but does not include such persons no within the intent of the definition as the CFTC may specify by rule or regulation or by order.

[2] In the past, the CFTC appears to have taken the position that the operator of a mutual fund is the registrant, on behalf of its portfolio, or itself. See *Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Pool Operator,"* April 23, 1985, nn. 30, 32 and text accompanying such notes, 50 FR 15868, 15871-72.

[3] The proposed rule, *Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations*, 76 FR 7976 (February 11, 2011), was issued at the urging of the NFA, which filed a petition with the CFTC seeking the amendments contained in the proposal. The NFA's petition to the CFTC can be accessed at http://www.nfa.futures.org/news/newsPetition.asp?ArticleID=3630.

and premiums required to establish such positions will not exceed five percent of the mutual fund's liquidation value (*i.e.* net asset value),[4] after taking into account unrealized profits and unrealized losses on any such contracts it has entered into.

A Marketing Restriction - A mutual fund may not market participations in the fund as a commodity pool or otherwise as a vehicle for trading in (or otherwise seeking investment exposure to) the commodity futures, commodity options, or swaps markets.

In order to claim the Rule 4.5 exclusion, the CFTC would require a mutual fund to file a notice with the CFTC (via the NFA) in which the Fund would represent that it will comply with the requirements of the Hedging Restriction, the 5% Test and the Marketing Restriction.

Similar restrictions were in place under the prior version of Rule 4.5, but were removed in 2003, in part, since they were "too restrictive for many operators of collective investment vehicles [including registered investment companies] to meet."[5] Significantly, in removing these restrictions, the CFTC also explained that the 2003 amendment would have "the added benefit to all market participants of increased liquidity." [6]

Rule 4.5 Should Not Restrict a Mutual Fund's Use of Swaps

As a threshold matter, Federated does not believe that restrictions under Rule 4.5 (*e.g.*, the Hedging Restriction) should apply to swaps, as that term is defined under the Dodd-Frank Act. Simply put, Federated does not believe that it (or any other industry participant or regulator) can realistically assess the effect of applying such restrictions to swaps, since the state of regulatory reform on that segment of the derivatives market is in such an unprecedented state of uncertainty and evolution.

The Proposed Hedging Restriction and 5% Test

The proposed amendments to Rule 4.5 would require a mutual fund to represent that it will use commodity futures or commodity options contracts, or swaps solely for bona fide hedging purposes within the meaning and intent of CFTC Rule 1.3(z)(1) (the "Hedging Restriction") and, to the extent the use of the contracts do not fall within the definition of bona fide hedging, that the "aggregate initial

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[4] According to the CFTC, the liquidation value of an entity's portfolio is "sometimes also referred to as the net asset value" *Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons From the Definition of the Term "Commodity Pool Operator"*, January 28, 1992, 58 FR 6371.

[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, 68786 (Nov. 13, 2002).

[6] *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Trading Advisors,* 68 FR 12622, 12626 (March 17, 2003).

margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the qualifying entity's portfolio" (the "5% Test").[7]

To understand whether a fund may rely on the exclusion of Rule 4.5 (*i.e.*, by, in pertinent part, making the representation regarding compliance with the Hedging Restriction and the 5% Test), it must be understood whether the fund's investments fit properly within the meaning of "bona fide hedging" under Rule 1.3(z).

CFTC Rule 1.3(z) defines bona fide hedging to mean "transactions or positions in a contract for future delivery on any contract market, or in a commodity option, where such transactions or positions normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and where they arise from" the potential change in the value or cost of assets, liabilities, or services, provided or purchased, whether now or anticipated. Moreover, "no transactions or positions shall be classified as bona fide hedging unless their purpose is to offset price risks incidental to commercial cash or spot operations and such positions are established and liquidated in an orderly manner in accordance with sound commercial practices and, for transactions or positions on contract markets subject to trading and position limits in effect pursuant to section 4a of the Act."

Federated strongly opposes the reintroduction of the bona fide hedging concept into Rule 4.5, as Federated believes that the concept of bona fide hedging is particularly ill suited to the use of derivatives (including financial futures contracts and options) by registered investment companies. Indeed, Federated's concerns are well founded, since on numerous occasions dating back almost to the original adoption of Rule 4.5 in 1985, Congress, the CFTC, and the CFTC's staff advisory committees have raised similar concerns with respect to the application of that definition to the use of financial futures by institutional investors.[8]

> First, in November of 1985, key members of the CFTC's staff published a paper entitled, The CFTC's Hedging Definition – Development and Current Issues, in which the authors analyzed the suitability of the bona fide hedging definition with respect to the use of financial futures by registered investment companies. On the basis of economic analysis, the authors concluded that the concept of bona fide hedging, while appropriate in the context of the use of physical commodity derivatives by commercial / production enterprises, was largely inapplicable to the use of financial derivatives by institutional investors.

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[7] Proposed Rule 4.5(c)(2)(iii)(A), *Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations*, 76 FR 7976, 7985, 7989 (February 11, 2011): Such calculation shall be made after taking into account "unrealized profits and unrealized losses on any such contract" entered into. *Id.* Additionally, the calculation may exclude the in-the-money amount at the time of purchase of an in-the-money option. *Id.*

[8] The CFTC's Hedging Definition – Development and Current Issues, Blake Imel, Ronald Hobson, and Paula Tosini, November 1985. The authors were, respectively, the CFTC's Deputy Director, Special Assistant to the Director and Director, Division of Economic Analysis.

Second, in 1986, the Agricultural Committee of the House of Representatives recognized, based upon the testimony of several witnesses, that

> [D]epending upon how the definition [of bona fide hedging] is interpreted, it may not recognize certain new uses of financial futures and options by investment advisers, banks, and insurance companies that manage pension funds, mutual funds, and other portfolios who must choose among different investments with varying levels of risk and anticipated returns.

The committee also distinguished between speculative and non-speculative uses of futures contracts with the non-speculative category comprised of both risk reduction and risk management transactions. With respect to non-speculative transactions, the Agricultural Committee specifically stated that it,

> [S]trongly urges the [CFTC] to undertake a review of its hedging definition for the purpose of ensuring that the definition is, in fact, current with the legitimate needs and practices of the industry. As part of this review, the Committee wishes the [CFTC] to consider giving certain concepts, uses, and strategies "non-speculative treatment under the [Commodity Exchange Act] and relevant Commission regulations, whether under the hedging definition or, if appropriate as separate category…the concept of "risk management" by portfolio managers as an alternative to the concept of "risk reduction."

Third, in June of 1987, the CFTC's Financial Products Advisory Committee ("FPAC"), issued a report entitled, The Hedging Definition and the Use of Financial Futures and Options: Problems and Recommendations for Reform. In the report, the FPAC concluded that the definition of bona fide hedging was not compatible with modern portfolio management theories utilized by institutional investors and, as such, required significant amendments to function in the financial context. In arriving at this conclusion, the FPAC distinguished between the use of futures contracts for non-speculative (i.e., risk reduction and risk management) and speculative purposes. In the context of a mutual fund, risk reduction would offset the risks of a mutual fund's position in the cash market, but also include transactions intended to offset commercial risks (such as offsetting risks of redemptions or cash inflows). Risk management allows for "portfolio managers to effect prudent and non-speculative … strategies in a low-cost, flexible, and timely fashion by taking advantage of the transactional efficiencies provided by the futures and options markets."[9] In contrast, a speculative position "requires resources in excess of cash and cash-equivalents segregated for that purpose."[10] Significantly, one of the key recommendations of the FPAC was to revise CFTC Rule 4.5 to provide an exclusion from CPO regulation for otherwise-

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[9] The Hedging Definition and the Use of Financial Futures and Options: Problems and Recommendations for Reform, June 1987, 52. As background, the FPAC consisted of 15 industry members and two CFTC staff, including CFTC Commissioner Robert R. Davis.

[10] Id at 51.

regulated entities (including mutual funds) which use futures and options for risk management purposes. The following is the specifc recommendation of the FPAC:

> *[O]therwise-regulated entities whose futures and options positions are taken for risk-management purposes should be subject to the exclusion from the CPO definition provided in CFTC Rule 4.5 .... Where entities are otherwise regulated as defined in Rule 4.5, the exemption from CPO regulation should be extended to include risk-management activities. Requiring CPO regulation in such circumstances would duplicate other satisfactory registration and oversight requirements, and is unnecessary since the risk-management transactions contemplated are not speculative and are intended to facilitate the entities' investment functions ... [T]he Commission should take steps to ensure that the exclusions provided in Rule 4.5 extend to all risk-management practices.*[11]

Fourth, in a July 1987 interpretive statement, the CFTC clarified that an expanded understanding of bona fide hedging was necessary and interpreted the concept to include:

> 1. "balance sheet hedging," such as "offsetting net exposure to changes in currency exchange rates for the purpose of stabilizing the domestic dollar accounting value of assets which are held abroad."
>
> 2. hedging transactions, even if the hedge was not a temporary substitute for a later transactions in the cash market; and
>
> 3. other strategies, such as "portfolio insurance or dynamic asset allocation strategies that provide protection equivalent to a put option for an existing portfolio of securities" also qualify as bona fide hedging. [12]

Fifth, in a September 1987 interpretive statement the CFTC recognized that transactions entered into for "risk management" purposes were not speculative, although such transactions did not always reduce an institution's risk exposure and, as a result, did not qualify as bona fide hedges. According to the CFTC, risk management "serves to alter an institution's risk-return profile within the context of the institution's overall investment objectives and predetermined risk parameters."[13] On this basis, the CFTC approved a risk management exemption from statutory and regulatory limitations on the speculative trading of futures contracts. At the time, the CFTC elected – without any explanation or justification – to not create a similar exemption for CFTC Rule 4.5.

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[11] FPAC report pp.55-56 (emphasis added)

[12] Notice of Agency Interpretation, 52 FR 27195-01 (July 20, 1987).

[13] *Risk Management Exemptions from Speculative Position Limits Approved Under Commission Reg. §1.61*, 52 F.R. 34633, 34635 (Sep. 14, 1987).

Sixth, in an October 20, 1992 proposal to amend Rule 4.5, the CFTC recognized that the Financial Products Advisory Committee stated in its reports of its July 23, 1992 meeting that "*at the least*, §4.5 should be amended to permit otherwise regulated institutions to engage in a broader range of strategies without being subject to CPO registration."[14] However, rather than adopting a risk management exemption from Rule 4.5, the CFTC adopted the 5% Test to limit the amount of positions that do not qualify as bona fide hedges.

Finally, in an August 2003 release adopting the current version of Rule 4.5, the CFTC made three observations in its evaluation of the costs and benefits[15] of the removal of the bona fide hedging concept from Rule 4.5. First, the CFTC observed that such removal would not have a negative impact on the protection of market participants or the public "where the amendments relax existing requirements under the Act and the Commission's rules in order to be consistent with existing requirements under the federal securities laws and the SEC's rules." Second, the removal of bona fide hedging would improve efficiency and competition by "removing barriers to participation in the commodity interest markets, resulting in greater liquidity and market efficiency." Third, this removal would also increase the availability and use of "risk management alternatives for Rule 4.5 eligible persons, as well as for CPOs and CTAs."[16]

As mentioned previously, Federated believes that this regulatory history supports its opposition to the re-instatement of the Hedging Restriction and 5% Test.

Further, Federated asks the CFTC to consider the fact that any reinstatement of these limitations would directly contradict the conclusions of the CFTC in 2003 that underlie the current version of Rule 4.5: namely, mutual funds will be exposed to duplicative and conflicting regulatory structures and the limitations may decrease the use of futures contracts by mutual funds, harming market liquidity. With respect to market liquidity, Federated notes that the timing of such a decrease could have significant and adverse unintended consequences for both the derivatives and securities markets, especially when combined with any shocks to liquidity that may arise as a result of the concurrent, unprecedented level of regulatory reform under the Dodd-Frank Act.

If, however, the CFTC chooses to reinstate the Hedging Restriction and the 5% Test, then Federated urges the CFTC to adopt a risk management exemption for purposes of Rule 4.5, as originally proposed

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[14] *Exclusion for Certain Otherwise Regulated Persons From the Definition of the Term "Commodity Pool Operator,"* 57 FR 47821 (October 20, 1992) (emphasis added).

[15] The CFTC evaluates a regulation under "five broad areas of market and public concern: Protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations." *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues*, 68 FR 47221, 47230 (October 14, 2003).

[16] *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues*, 68 FR 47221, 47230 (October 14, 2003).

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by the CFTC's FPAC in its 1987 report.[17] In support of this position, Federated notes that practically any use of a financial futures contract by a registered investment company for efficient portfolio management purposes is a "risk management" transaction from the perspective of the fund and its shareholders. The following are examples of how mutual funds use derivatives for risk management purposes.

> *Duration Management*. Mutual funds use futures to manage the duration of the underlying portfolio of fixed-income investments. Duration can be shortened to protect the fund against an increase in interest rates or lengthened in order to reduce reinvestment risk that would result from an implementation of the fund's investment strategy in a period of declining rates.

> *Long Short Investment Strategies*. Mutual funds may use long short investment strategies to modify their exposure to particular market sectors without having to sell individual portfolio holdings that its manager views as otherwise attractive investments. For example, an equity fund may hold a variety of individual stocks across various market capitalization sectors – large cap, small cap and mid cap. If the fund's manager believes that large cap stocks will, on the whole, outperform small cap stocks, then it could adjust its exposure to these two market sectors by selling small cap stocks in its portfolio and buying additional large cap stocks. However, this may not be desirable, since the stock of any individual company may, in the manager's opinion, have the potential to outperform the broader market sector. As an efficient alternative, the fund could use stock index futures to increase its exposure to large cap sector and decrease its exposure to the small cap sector without having to sell any individual portfolio securities.

> *Covered Call Writing*. Mutual funds that invest in government securities write call options on Treasury bond futures to generate income for fund.

> *Exposure to Credit Market*. A mutual fund may use credit default swaps and other credit derivatives to obtain exposure to various credit markets – corporate, municipal, sovereign bond, non-U.S. government (so-called sovereign debt), etc. Specifically, the fund can enter into credit derivatives to gain exposure to the credit of a particular issuer and generate income for the fund or to protect the fund from a deterioration in the creditworthiness of a particular issuer.

Specifically, a mutual fund could implement each of the above examples (except for "Covered Call Writing") by entering into transactions in the cash market (i.e. securities transactions) instead of using derivatives.

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[17] Federated does not express a view on whether the risk management exemption is structured as a separate exemption or, alternatively, a component of the definition of *bona fide hedging* under CFTC Rule 1.3(z). We also note that in adopting the FPAC's recommendation by extending exclusion to all risk-management practices for otherwise regulated entities, the other aspects of the bona fide hedging definition in effect in 1987 (substitution, incidental, etc.) should not be reintroduced. Indeed, as explained in the FPAC's report, the aspects of the definition in effect in 1987 were arbitrary and, as a result, difficult to properly administer.

Finally, prior to further consideration of the 5% Test, Federated urges the CFTC to conduct rigorous studies to determine whether or not a 5% limit is appropriate in light of existing margin levels on all futures and derivatives products. Federated believes that such a study must be undertaken to account for changes in the futures markets, such as the introduction of single stock futures contracts, that have occurred since the introduction of the 5% limit in 1985. Federated believes that this study must not be undertaken until after market participants and the CFTC understand all material proposals in respect of margin on all classes of swaps. Otherwise, there is a material risk of having adverse, unintended consequences on market liquidity and efficiency.

The Proposed Marketing Restriction

1. Generally

The Marketing Restriction was an element of CFTC Rule 4.5 from the adoption of the rule in 1985 until 2003, when the current version of the rule was adopted. In connection with the adoption of the original Marketing Restriction element in 1985, the CFTC articulated its view that an:

> [A]n entity would be "marketing participations" in a manner inconsistent with the [restriction] if it was actively promoted as a 'hybrid – *e.g.*, a securities *and* a commodities – trading vehicle or as an investment vehicle in which commodity futures and options trading was particularly significant and critical to the growth of its assets, as opposed to being incidental to protecting those assets against a decline in value.'[18]

As part of the adoption of that version of the restriction, the CFTC expressed an intention to interpret the Marketing Restriction so as to allow the otherwise regulated entity to provide its investors with "promotional material required by and consistent with the policies of a qualifying entity's other Federal or State regulator."

In articulating this interpretation, the CFTC made two related points. First, the CFTC distinguished between "[the] marketing [of] a qualifying entity as a commodity pool and accurate disclosure of the entity's limited use of its commodity interests." Second, the CFTC stated that the Marketing Representation element "should permit a qualifying entity to describe accurately in its sales literature the limited use of its commodity interest trading and how it believes that use will be beneficial."[19]

As a threshold matter, Federated does not believe that the Marketing Restriction is a necessary component of Rule 4.5, since the SEC and FINRA heavily regulate the marketing and distribution of a registered investment company's shares. Having said that, if the CFTC decides to reintroduce the Marketing Restriction into Rule 4.5, Federated believes the Commission should clarify that the

[18] *Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Pool Operator"; Other Regulatory Requirements*, 50 FR 15868, quoting 49 FR 4778, 4882.

[19] *Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Pool Operator,"* April 23, 1985, 50 FR 15868.

restriction does not apply to statements made by a fund in its disclosure or marketing materials subject to and in compliance with SEC and FINRA regulatory requirements. Such clarification is more important now than it was in 1985, since the SEC has recently mandated that registered investment companies provide their shareholders with more robust registration statement disclosure describing the manner in which a mutual fund intends to use derivatives, as well as increased annual report discussion of the manner in which derivatives were used over the most recent reporting period.[20]

2. Otherwise Seeking Exposure

If adopted as proposed, the Marketing Restriction would be broader than the previous version of the Marketing Restriction that was in place from 1985 to 2003. Specifically, the prior version of Rule 4.5 contained a marketing restriction that prohibited a mutual fund from marketing itself as 1) a commodity pool or 2) a vehicle for trading in commodity futures or options. However, the proposed version of Rule 4.5 would, in addition to these two prohibitions, prevent a mutual fund from marketing itself as a vehicle "*otherwise seeking investment exposure to*" the commodity futures or commodity options or swaps markets. Neither the NFA's September 2010 petition nor the CFTC's February 2011 rule proposal provide any explanation for the expanded language.

As pointed out by the Investment Company Institute in an October 18, 2010 letter[21] to the CFTC commenting on the NFA's petition, many mutual fund complexes offer mutual funds on the basis of a structure whereby one fund (an "investing fund") invests in another fund (an "underlying fund"). The ICI's letter raised the particular concern that a broad interpretation of the "*otherwise seeking investment exposure*" language in proposed Rule 4.5 could result in a prophylactic prohibition on the use of futures contracts by an underlying fund, even if that fund used derivatives in a manner that otherwise complied with the requirements of Rule 4.5 (*i.e.*, for bona fide hedging purposes or in a manner that complies with the 5% Test).

Currently, the funds in the Federated mutual fund complex (the "Federated Funds") utilize the investing fund / underlying fund structure for purposes unrelated to the trading of derivatives. In particular, Federated has created several registered investment companies into which other Federated funds invest in order to obtain exposure to a particular type of investment (*e.g.*, high yield fixed income investments, mortgage backed securities, emerging market fixed income investments, etc.) in a cost efficient manner. Some of these underlying funds may, in turn, invest in derivatives, including futures contracts and options on such contracts.

In the first instance, Federated believes that the Marketing Restriction that was in place from 1985 to 2003 should not be expanded in the manner proposed by the CFTC in its February 2011 proposal. In particular, the "*otherwise seeking investment exposure*" prohibition should not be a part of the

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[20] SEC, Letter to Investment Company Institute re: Derivatives-Related Disclosures by Investment Companies, July 30, 2010. http://www.sec.gov/divisions/investment/guidance/ici073010.pdf

[21] The Investment Company Institute comment letter may be found on the CFTC's website, under comments for the proposed rule published October 18, 2010 in 75 FR 56997.
http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26303&SearchText=

Marketing Restriction, if adopted as part of a final rule amendment. If, in the alternative, this prohibition is included in the Marketing Restriction, Federated believes that the CFTC should clarify that the use of an investing fund / underlying fund structure does not result in the investing fund *otherwise seeking investment exposure* to the futures markets solely because the registration statement of either the investing fund or the underlying fund discloses to shareholders that their respective investment strategies permit each fund to invest in commodity futures or options contracts.

CONCLUSION

Federated understands the Commission's desire to address regulatory concerns that relate to the offering of futures-only regulated funds without any oversight by the CFTC. However, Federated does not believe that it is appropriate to jeopardize the efficiencies and risk management practices that futures and swaps provide for mutual funds, and the cost savings to shareholders thereof. Furthermore, as described above, Federated believes that the legislative history indicates that careful consideration went into the decision to remove the restrictions and limitations that the CFTC is now proposing to re-instate. However, should the CFTC decide that the proposed rulemaking is necessary, Federated implores it to undertake a rigorous study, as it has in the past, with the help of the entire industry, to better understand the full ramifications of the proposals. As described above, such a study may be most effective after the regulatory landscape established by the Dodd-Frank Act is more settled. Finally, if a study is not feasible, Federated urges the CFTC to review the 1987 report and adopt the recommendation of the FPAC.

Please contact me at (412) 288-2614 with any questions about this submission. Thank you.

Very truly yours,

/s/ Andrew P. Cross

Andrew P. Cross
Reed Smith LLP

cc: Michael R. Granito
G. Andrew Bonnewell
Peter J. Germain