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April 12, 2011

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

Re: Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (§§ 4.5, 4.13, and 4.14) (the "Proposed Rule")

Dear Mr. Stawick:

On behalf of Rydex SGI, we appreciate the opportunity to comment on the Commodity Futures Trading Commission's (the "Commission" or "CFTC") Proposed Rule. 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 than $17 billion in customer assets.

We support the Commission's goal to ensure that retail investors are protected through appropriate regulation of the vehicles in which they invest. For the reasons discussed below, however, we do not believe that the proposed amendments to Regulations 4.5 and 4.13 are necessary or appropriate to achieve this goal.[1] Further, we believe that the Proposed Rule would have a number of problematic consequences for those entities subject to the Proposed Rule and regulators alike. Certain of these problematic consequences have been identified in the multitude of comment letters submitted in response to the National Futures Association's ("NFA") Petition to the Commission to amend Regulation 4.5 ("NFA Petition"), but it is likely that there are still other problematic consequences that have yet to be recognized or fully appreciated. Moreover,

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1 *Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations; Proposed Rule*, 76 FR 7976 at 7976-8066 (February 11, 2011).

in this time of extreme federal fiscal stress, during which the need to conserve federal spending and allocate limited resources as efficiently as possible has become paramount, the Commission should heed the direction of the President and "tailor its regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations."[2] Therefore, we strongly encourage the Commission to be circumspect in its decision to develop a new regulatory scheme for financial products that are already highly regulated and address the ramifications of the Proposed Rule.

I. Administrative History

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." Regulation 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.[3]

Regulation 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 Regulation 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 Regulation 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.[4]

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2 *Improving Regulation and Regulatory Review*, Executive Order of the President of the United States (Jan. 18, 2011).

3 *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)).

4 *Id.* at 15882-15883.

As the Commission gained experience in the administration of Regulation 4.5, the Commission amended it to, among other things, simplify it by eliminating the cash set-aside test and reduce the limitation on trading commodity interests 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."[5]

In November 2002, the Commission again attempted to expand the exclusions from regulation as a CPO and commodity trading advisor ("CTA"). In an advanced notice of proposed rulemaking, the Commission noted that the criteria for registration relief under Regulation 4.5 and Regulation 4.13 were "too restrictive for many operators of collective investment vehicles to meet."[6] The Commission subsequently proposed to expand existing registration relief for certain CPOs and CTAs, including by eliminating as conditions to eligibility under Regulation 4.5 any limitations on the amount of trading in commodity interests and the related disclosure requirement.[7] 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.[8]

In August 2003, the Commission adopted amendments to Regulation 4.5 eliminating the trading restrictions, related disclosure requirement, and the prohibition against the qualifying entity 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 Regulation 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").[9] In adopting the amendments, the

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

6 *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).

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

8 *Id.* at 12625.

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

Commission stated that it had eliminated the marketing limitation under Regulation 4.5 in response to comments it received that "the 'otherwise regulated' nature of the qualifying entities specified in Regulation 4.5 would provide adequate customer protection."[10]

The Proposed Rule, 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

The primary motivation for the 2003 Amendments was the recognition that the qualifying entities were already more than adequately regulated by other regulators. Since the adoption of the 2003 Amendments, the federal regulation of investment companies, the investment advisers that manage them and the broker-dealers that distribute their shares has only become more extensive, and the mandates embedded in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") ensure that this regulatory vigilance will continue. Every facet of a registered investment company's operations is subject to federal regulation and oversight by one or more regulators. An exchange-traded fund registered under the Investment Company Act ("ETF"), for example, is regulated, directly and indirectly, by at least three different regulators – the SEC, Financial Industry Regulatory Authority ("FINRA") and the stock exchange on which the ETF's shares are listed (the "Listing Exchange").

Investment companies, in general, 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's website. In connection with its review of such disclosure, the SEC considers and comments on an investment company's description of its investment strategy and the accompanying risks with the goal of ensuring the retail investors are provided with ample and clear information about the investment company's strategy, the instruments in which it invests, and the risks associated with each. While a long-standing concern of the SEC staff's, the staff recently has intensified its focus on

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

an investment company's use of derivatives and the disclosure of such practices.[11] An investment company must provide a shareholder with a copy of the prospectus, or summary prospectus,[12] 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.[13]

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 by FINRA prior to being disseminated by the distributor to the retail public. A registered investment company's activities also are closely monitored and governed by the investment company's board of directors, which represent investors and protect their interests.[14]

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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11 U.S. Securities and Exchange Commission Letter to the Investment Company Institute, *Derivatives-Related Disclosures by Investment Companies*, (July 30, 2010) at http://www.sec.gov/divisions/investment/guidance/ici073010.pdf.

12 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.

13 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.

14 *Role of Independent Directors of Investment Companies*, Investment Company Act Release No. 24816 (Jan. 2, 2001).

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. The fact that registered investment companies are providing retail investors greater access to the commodities market while enabling such investors to gain such exposure through an investment vehicle they are familiar with, that is highly regulated, and that will limit an investor's losses to the amount such investor invested in the investment company should be encouraged and facilitated.

III. Potential Concerns Raised by the Proposed Changes to Regulation 4.5

If the Commission determines to limit the exclusion under Regulation 4.5, certain investment companies would be subject to regulation by both the SEC and the Commission. To the extent that SEC and Commission 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. Specifically, we encourage the Commission to consider the concerns set forth below.

A. Bona Fide Hedging Test

The adoption of the Proposed Rule would reinstate the condition that registered investment companies that wish to rely on the exclusion provided by Regulation 4.5 demonstrate that their use of futures and options contracts is solely for bona fide hedging purposes. While the Commodities Exchange Act ("CEA") Section 1.3(z) provides a definition of "bona fide hedging transactions and positions," the application of the test is still fraught with potential complications. In April 1985, the Commission itself recognized the potential complications posed by "anticipatory" or "long hedge" strategies and attempts to determine whether an entity had the intent to engage in bona fide hedging when it entered into the futures or options transaction.[18] While the Commission's intent was to avoid case-by-case determinations, the ever evolving complexity of the investment strategies used by registered investment companies will likely make it a costly endeavor both for the Commission and the registered investment company to attempt to monitor the investment company's compliance with the bona fide hedging test.

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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 *Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Pool Operator"; Other Regulatory Requirements* (April 23, 1985).

B. 5% Test

As the Commission noted in adopting the 2003 Amendments to Regulation 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 broad-based stock index and security futures (single stock or narrow-based indices) are such that the use of such contracts would be limited under the 5% Test. The SEC has long treated such instruments as securities, and registered investment companies commonly use such futures contracts to implement investment strategies that frequently are not aimed at achieving exposure to the commodities market, but which are not used solely for bona fide hedging purposes either. For example, a significant number of registered investment companies that seek to track or outperform the performance of a securities index invest in financial futures contracts to obtain exposure to their underlying securities indices, such as the S&P 500 Index, and the securities market, in general. Financial futures contracts are sometimes the only financial instrument that can be used to achieve this exposure, and frequently are the most economically efficient tool to achieve such exposure. Thus, the current iteration of the 5% Test could subject a significant number of registered investment companies that have no intent to obtain and do not market themselves as providing commodities exposure to the oversight of the Commission. Such a result would incur unnecessary monitoring and compliance expense for both the Commission and the investment company. This result would be exaggerated if swap contracts also are determined to count toward the 5% Test. This unintended result could be avoided if the Commission revised the proposed 5% Test to exclude from the 5% calculation the margin associated with financial futures contracts. At the very least, the Commission should consider incorporating its previous no-action positions permitting registered investment companies to use the aggregate notional value of their non-hedging futures or options contract positions to determine compliance with the 5% Test.

C. Marketing Representation

As originally adopted, Regulation 4.5 prohibited an investment company seeking to rely on Regulation 4.5 from marketing its participations "as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures or commodity options markets."[19] The Proposed Rule expands the pre-2003 representation to include marketing the investment company 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 any marketing prohibition adopted be narrowly tailored so as to prevent soliciting investments in products clearly subject to the Commission's

[19] 50 FR 15868 at 15883.

jurisdiction only. We also encourage the Commission to augment its guidance concerning what constitutes marketing subject to the restriction and objective standards to distinguish between factual disclosure about an investment company's investments and descriptive disclosure created solely for marketing purposes. In addition, to avoid interfering with existing SEC disclosure requirements, the Commission should exclude from the definition of marketing all regulatory-required disclosure such as an investment company's prospectus and SAI and any supplements thereto, as well as other regulatory documents, including proxy statements. Such an exclusion would ensure that an investment company's efforts to fully disclose the characteristics and practices of the investment company are unhampered by competing Commission content restrictions.

D. Identity of the CPO

The Proposed Rule raises a host of other concerns for those registered investment companies that will likely no longer be able to rely on the exclusion provided by Regulation 4.5. Of particular importance is the uncertainty concerning which entity involved in the operation of a registered investment company would be deemed to be the CPO of such investment company. In addition to regulatory differences, the structure of most registered investment companies does not lend itself to the existing regulatory scheme for commodity pools. A registered investment company's investment adviser, principal underwriter, and board of directors could each arguably be deemed to be the CPO.[20] However, if past Commission guidance is any indication the Commission may be disposed toward recognizing the investment company's directors and officers as the persons required to register as a CPO.[21] As mentioned 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

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[20] 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 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).

[21] In response to a request to the Commission to opine on whether a registered investment company's registered investment adviser or registered broker-dealer would be considered to be a CPO, the Commission stated "[w]e historically have treated registered investment companies and their officers and directors as those persons subject to CPO regulation. . . Accordingly we do not believe any such opinion is necessary at this time." *Division of Trading and Markets Staff Interpretive Letter 84-11*, Comm. Fut. L. Rep. (CCH) para. 22,290, at 29,457 n. 5 (July 17, 1984).

independent directors to take on additional regulatory duties, comply with certain proficiency requirements (*e.g.*, the Series 3), and assume additional 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. Such an effect, in turn, would compromise one of the SEC's most integral oversight mechanisms to the disadvantage of investors and regulators. Given the goals identified by the staff of collecting and monitoring information about the commodities investment activities of these investment companies, we believe that the appropriate entity to be recognized as a CPO of an investment company is the investment company's primary investment adviser.

E. Use of a Single Disclosure Document

As mentioned previously, registered investment companies are required to file registration statements on Form N-1A that consist of a prospectus, SAI and related exhibits. The disclosure goals of and content required to be included in a Form N-1A registration statement are not unlike those of a Disclosure Document required to be filed by commodity pools subject to regulation by the Commission. Therefore, we encourage the Commission and the SEC to consider how best to revise the Form N-1A registration statement to accommodate the additional items that the Commission currently believes are lacking from Form N-1A, so that a registered investment company that is no longer eligible to rely on Regulation 4.5 need only generate, maintain and distribute a single disclosure document to its investors. A single disclosure document not only will help to conserve compliance costs, and thus the expense to investment company shareholders, but will help to ensure that investors are not inundated with disclosure documentation that cause confusion or produce apathy toward reviewing such disclosure. Working with the SEC to produce requirements for a single disclosure document also will necessitate a compromise with respect to the SEC's and the Commission's requirements related to the presentation of past and related performance and fees and expenses, which are currently at odds with each other.

Other of the Commission's regulations relating to a CPO's disclosure obligations also will need to be reconciled with the existing disclosure rules applicable to registered investment companies. For example, Regulation 4.21 requires a CPO to deliver a Disclosure Document to a prospective investor prior to or at the time the CPO delivers to the investor the subscription agreement for the commodity pool and to obtain an acknowledgement of receipt of such Disclosure Document before the pool accepts purchase proceeds from the prospective investor. Shareholders of registered investment companies may not purchase shares of the investment company directly from the investment company, but rather through broker-dealer intermediaries, supermarkets, or, in the case of an ETF, in the secondary market. While the Securities Act of 1933, as amended (the "Securities Act") requires that an investment company's prospectus precede or accompany the sale of its shares, this requirement is typically satisfied by delivering the prospectus with the shareholder's trade confirmation. Because prospective shareholders often do not interact with

the investment company directly, it would be impractical to require an investment company to deliver its prospectus to a shareholder prior to or at the time the prospective shareholder decides to purchase a share of the investment company. For the same reason, it is not reasonable to expect that investment companies will be able to secure an acknowledgement from each and every prospective shareholder before purchase proceeds exchange hands. Nor is it practical for investment companies to delegate such responsibilities to the broker-dealer intermediaries. Moreover, unlike traditional commodity pools, investment companies' disclosure documents are typically made available to the public on their web sites and are always available on the SEC's filing site, EDGAR.

In the context of regulating exchange-traded products ("ETPs") that invest in commodities and commodities-related instruments, the Commission has demonstrated its ability to exercise flexibility in accomodating the exchange-traded nature of the ETPs. 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.[22] The Commission also has provided relief from registering as a CPO for certain independent directors and trustees of actively managed ETPs.[23] If the Commission determines to adopt amendments to Regulation 4.5 we urge it to also consider providing comparable relief for investment companies.

F. Frequency of Distribution of Account Statements

Registered investment companies are required to provide annual and semi-annual reports and generally provide quarterly financial statements to shareholders. In comparison, Regulation 4.22 requires CPOs to provide monthly statements to pool participants. Unlike commodity pools, investment companies may be sold directly to shareholders, through third-party broker-dealers and, in the case of ETFs, on a securities exchange. Due to the widely held nature and, for ETFs, 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, to the extent that shares are sold directly to shareholders, Rydex/SGI and other investment company complexes typically provide shareholders with internet or telephonic access to their relevant account information, including

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22 *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).

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

the net asset value of their account holdings. Therefore, the Commission should consider excepting registered investment companies from this requirement.

G. Transition and Implementation of Proposed Rule

If the Commission proceeds with the adoption of the Proposed Rule or substantially similar changes, the Commission should consider providing for a sufficient transition period during which investment companies either can prepare to comply with the Commission's regulations or make other arrangements so as to not be subject to such regulations. For those registered investment companies that would no longer be able to rely on the exclusion afforded by Regulation 4.5, preparing to comply with the disclosure, compliance and reporting obligations of a commodity pool and registered CPO would require significant effort in terms of time and expense on the part of investment companies and their service providers. The disclosure requirements for investment company complexes such Rydex/SGI would require revamping existing or creating new disclosure documents for numerous investment companies, which, in turn, would require coordination with the investment company's service providers, including the investment company's auditors and legal counsel, and additional filings with and review of such filing by the SEC and NFA. In addition to such coordination, the reporting and compliance requirements would require investment companies and their service providers to augment or rebuild their existing compliance and reporting infrastructures to accommodate the additional items to be monitored and the increased reporting frequency. Of course it is possible that some registered investment companies may decide that the additional regulatory burden and oversight is not worth while and, thus, divest their futures and options positions in favor of other instruments, such as structured notes, revise their investment strategies, or liquidate. These investment companies also should be afforded sufficient time to carry out such changes so as to avoid disposing of their investments at inopportune times and incurring unnecessary losses for their investors.

We would prefer that the Commission exempt investment companies that have previously claimed exclusion under Regulation 4.5 from complying with the Proposed Rule; however, at a minimum, we recommend that the Commission consider providing for at least twelve-month transition period if it proceeds with the adoption of the Proposed Rule. While the transition period necessary will vary greatly from investment company to investment company depending on the number of investment companies affected and the resources of the investment company complex, among other factors, such a transition period should accommodate most investment company complexes. Such a transition period also would be comparable to the transition periods the SEC has provided for other significant regulatory measures such as the adoption of Rule 38a-1 and the enhanced disclosure and summary prospectus initiative, which provided for transition periods of nine and at least ten months, respectively.

IV. Registered Investment Companies Investment in Offshore Subsidiaries

A. An Investment Company's Use of CFCs to Gain Exposure to the Commodities Market Poses No Threat to Investment Company Shareholders

The Commission and the NFA have both implicated certain investment companies that invest in futures and options through wholly-owned subsidiaries organized offshore as the primary motivation for the Proposed Rule as well as other concurrent regulatory initiatives.[24] Interestingly, there a relatively few registered investment companies that fit this description in comparison to the number of registered investment companies that invest in futures, options and swaps for reasons other than to seek exposure to the commodities market. Moreover, no evidence has been presented or any allegations made that the registered investment companies that obtain commodities exposure through their wholly-owned CFC have harmed investors in any way or that the SEC's oversight of such investment companies has in some way proved deficient.

While the CFCs of such registered investment companies are not themselves registered, they should not be thought of as operating wholly outside of regulatory oversight. The PLR relief that the registered investment companies rely on to invest in their CFCs imposes three very important conditions: (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 (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

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[24] Multiple investment company 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 certain derivatives, including commodity-based swaps, 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. 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 investment company level and then again as dividends distributed to its shareholders. Accordingly, it is paramount to the operation of all registered investment companies that they qualify as RICs under Subchapter M. The IRS subsequently issued several private letter rulings ("PLRs") in which it ruled that, subject to certain conditions, 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.

limited to 25% 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.[25] 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.[26]

As mentioned previously, a registered investment company's board of directors, which is typically composed of a majority of independent directors,[27] 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.[28] A registered investment company's board of directors is responsible for approving, among other

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25 Item 4, Form N-1A.

26 Regulation S-X § 3A-02.

27 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.

28 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*, 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.").

things, the investment in the CFC. 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 CFC. Accordingly, investment company boards of directors routinely request and review information about the CFC's investment activities, operations, expenses, and performance.

Additionally, a number of the mutual fund complexes that operate CFCs 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 CFC's interests are completely aligned with those of the investment company. For these reasons, we do not believe that an investment company's investment in a CFC warrants the measures proposed by the Commission.

B. It is not Necessary to Rescind the Exemptions Provided by Regulation 4.13

The CFCs and the registered investment advisers that manage the CFCs and their investment company parents generally rely on the exemption provided in Regulation 4.13(a)(4). Regulation 4.13(a)(4) provides that a person is exempt from registration as a CPO if the interests in the pool are exempt from registration under the Securities Act and the CPO reasonably believes that all pool participants are Qualified Eligible Persons as defined in Regulation 4.7. The Commission created this additional exemption at the same time and for the same reasons it relaxed Regulation 4.5. The Commission is now proposing to rescind the exemption provided by Regulations 4.13(a)(3) and (a)(4) because the pools relying on such exemption are not subject to the oversight of the Commission and "there is very little if any transparency or accountability over the activities of these participants."[29] The Commission is proposing to rescind the exemption provided by Regulation 4.13(a)(4), in particular, because it imposes no limits on the amount of commodity interest trading the pool can engage in.

While the proposing and final rule releases do not detail all of the considerations identified in support of the creation of the exemption, presumably a significant consideration was the fact that the investors in such a pool would be sophisticated and capable of appreciating and withstanding the risks associated with trading in commodity interests. This consideration is no less valid today. It is especially valid when referring to the CFCs that are wholly-owned by registered investment companies. Not only are registered investment companies and their investment advisers capable of appreciating and handling the risks associated with investments in commodity interests, but as pointed out previously the interests of the CFC and its sole investor are completely aligned.

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[29] *Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations; Proposed Rule* (February 11, 2011).

Moreover, if the Commission adopts the Proposed Rule requiring registered investment companies that wholly-own CFCs to register as CPOs, requiring the CFCs to also register would be redundant and lead to duplicative oversight and compliance efforts by both the registrants and the regulators. In addition, the fact that the CFC's financial information, including its portfolio holdings, are consolidated with those of its registered investment company parent provides a high degree of transparency into the CFC's investment activities. Should the Commission adopt changes to Regulation 4.5, the CFC also would be accountable to the Commission vis a vis the Commission's oversight over the registered investment company parent. Even in the absence of changes to Regulation 4.5, the CFC will continue to be accountable to the SEC for similar reasons. Therefore, we believe the Commission should consider preserving the exemptions provided by 4.13 with regard to CFCs that are wholly-owned by registered investment companies.

V. Conclusion

The Commission has indicated that it believes the Proposed Rule will enable it to monitor the activities of registered investment companies that are *de facto* commodity pools and prevent regulatory arbitrage, but it has not identified a regulatory gap or the existence of harm to investors by such investment companies nor has it attempted to demonstrate that registered investment companies are in fact engaging in regulatory arbitrage between what we believe are comparable regulatory schemes. For these reasons and the reasons discussed above, including in particular, the regulated nature of registered investment companies and the customer protections currently provided by the federal securities laws and the SEC, we do not agree that there exists a need for the Proposed Rule. Nonetheless, if the Commission determines it is prudent to proceed with the adoption of the Proposed Rule or substantially similar rule changes to Regulations 4.5 and 4.13, we hope it will carefully consider the possible consequences of such changes and attempt to carefully harmonize its regulatory scheme with those of other regulators that currently are directly and indirectly regulating the activities of registered investment companies. We also encourage the Commission to demonstrate, as it has in the past, its willingness to be flexible and pragmatic when designing its regulatory scheme with respect to registered investment companies in an effort to ensure as little disruption and expense for such investment companies and their shareholders as possible while continuing to foster innovation in the marketplace.

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: Amy Lee
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