Statement of

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Treasurer
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at the

U.S. Commodity Futures Trading Commission

Roundtable Discussion

Re: Issues Faced by Managed Funds Industry Members with Respect to the Proposed Revision to Commission Regulation 4.5 and the Proposed Rescissions of Commission Regulations 4.13(a)(3) and (a)(4)

July 6, 2011

I am Jennifer Setzenfand, a Vice President and Senior Trader of Global Equities and Derivatives at Federated Investors, Inc. in Pittsburgh, Pennsylvania.[1] I appear today in my capacity as the Treasurer of the Security Traders Association (STA), and on behalf of the Security Traders Association, I would like to thank the Commission for the opportunity to speak today.

The Security Traders Association is a global trade organization for professionals in the securities industry. With 25 affiliates throughout North America, we provide a forum for our members, who represent buy-side and sell-side institutions, broker-dealers, ECNs, exchanges,

[1] Since 1955, millions of investors in the United States and around the globe have relied on Federated Investors, Inc. for world-class investment management. Federated has grown to become one of the nation's largest investment managers with assets under management of approximately $355 billion, including domestic and international equity, fixed income and money market portfolios. Federated's diversified product line is distributed to individual investors through the 4,900 financial intermediaries and institutions with whom we do business.

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market makers, and hedge funds to share their distinct perspectives on issues facing our securities markets. Founded on the principle "Dictum Meum Pactum" (translated: "my word is my bond"), STA is an assembly of market practitioners dedicated to the protection, growth and integrity of our nation's financial markets. Our ultimate goal is to provide investors, both retail and institutional, with the most liquid, transparent, fair and efficient markets in the world.

I am here today to comment on behalf of the members of STA regarding CFTC Rule 4.5. Before Rule 4.5 was implemented in 2003, registered investment companies ("RICs") investing in commodity futures were restricted to using futures only for bona fide hedging purposes and were limited to only using 5% of the liquidation value of the fund towards aggregate initial margin required to establish a position. They were additionally prohibited from marketing their funds to the public as Commodity Pool Operators ("CPOs"). RICs who did not comply with these requirements registered with the CFTC as CPOs.

In 2003, after a robust and appropriately lengthy process of review and industry input, Regulation 4.5 was adopted by the CFTC, providing RICs who were registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940 ("1940 Act") an exemption from registering as a CPO. This exemption eliminated the onerous responsibilities of dual registration with both the SEC and the CFTC. Since the inception of Rule 4.5, portfolio managers at RICs have used futures and swaps as effective investment alternatives for managing risk and as efficient tools for obtaining the investment strategy of their funds. On January 26, 2011, the CFTC proposed amendments to Rule 4.5 that would repeal the exemptions established in 2003. The proposed amendment, which we are here today to discuss, would reinstate the previous requirements that applied prior to 2003, and place additional restrictions on registered investment companies' use of futures and swaps.

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During an April 13, 2011 hearing of the Subcommittee on General Farm Commodities and Risk Management Committee of Agriculture, Karrie McMillian, General Counsel to the Investment Company Institute (ICI), commented that:

> "The CFTC maintains that it needs to 'stop the practice of registered investment companies offering futures-only' products without CFTC oversight. But the proposal goes beyond funds that could reasonably be described as 'futures-only' products. Instead, the amendments are sweeping and would affect hundreds, if not thousands, of funds.... It is important to emphasize that the two sets of regulation that may be imposed on these funds are both duplicative and contradictory. And the funds affected could include basic S&P 500 stock funds or tax-exempt bond funds – products for buy-and-hold investors and retirement savers, not for speculators in the futures and options markets."[2]

The STA agrees with Ms. McMillian's comments and we share ICI's concern as to the public policy wisdom of subjecting so many broadly held funds to dual registration requirements. We urge the commission to review the 18 examples of requirements applicable to RICs and CPOs identified by ICI in Appendix A to its letter to the SEC and CFTC dated April 12, 2011.[3]

The STA believes adopting regulations which require RICs, who are already covered under the 1940 Act, to dually register with both the CFTC and SEC in order to trade futures contracts, will adversely affect those RICs. As stated earlier, portfolio managers view futures as an effective investment alternative in managing risk and fund flows. Restricting a portfolio manager's ability to trade in futures would force them to trade in alternative investments which

[2] http://www.ici.org/policy/current_issues/11_house_implementing_doddfran

[3] http://www.ici.org/pdf/25107.pdf

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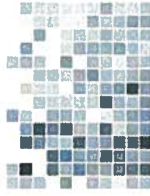

could be inferior as measured by liquidity and tracking to the fund's investment objectives. These consequences could result in implicit losses, or costs, to investors.

We recognize that the proposed amendment provides an exemption for bona fide hedging purposes. In CFTC Rule 1.3(z)(1) (the "Hedging Restriction") bona fide hedging is defined 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 transaction 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."

We do not feel that this definition fully encompasses all the ways that mutual funds use futures. The vagueness of the definition as it currently stands leaves much room for error and interpretation. For example, if a fund uses futures in place of stocks that are purchased at a later date, does that qualify as "a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel"? The very language in the definition of bona fide hedge referencing physical/commercial marketing channels makes our point that CFTC regulation is not relevant for mutual funds that are already registered with the SEC.

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Beyond the views we expressed in our comment letter on April 14, we suggest that in light of the Dodd Frank Act's mandate of coordination between the SEC and CFTC, and as an extension of the discussion at this Roundtable today, a "joint advisory committee" be formed to review the complications that have been identified by the STA and the many other parties who have expressed concerns with the proposed reinstatement of the pre-2003 situation through these amendments to Rule 4.5. A committee of CFTC and SEC representatives, assisted by experts from the mutual fund industry, could then better review the conflicting regulations and determine how to best proceed. We are convinced that further research should be conducted to better understand how mutual funds are using futures products and the explicit and implicit costs a revision of Rule 4.5 would have on investors.

Mutual funds are investments that enable retail investors to save for their future. Ordinary people invest in funds to save for a home, retirement, college, and a host of other important needs. Mutual funds also represent a means of investing money in a diversified fashion. Futures products provide the portfolio managers of these mutual funds an alternative to manage portfolio risk and cash flow, while they seek to obtain a stated objective of a fund. For example, when a fund experiences an inflow of cash from investors, portfolio managers are required to maintain market exposure in accord with the investment strategy of the fund. Portfolio managers may choose to use futures as an interim investment alternative while security purchases are completed. Their decision is often based on measuring the liquidity of the futures product and the liquidity of the underlying securities. Portfolio managers consider liquidity in their execution strategy so as to minimize market or price impact and to maximize investor returns. The availability of futures as an investment option is more critical in situations when a new fund is established and inflows of cash are very high. Consideration needs to be given to the impact that restricting mutual funds' use of futures will have on the equity and

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derivative markets. The compelling need for risk management tools is present even if futures are not an allowable investment vehicle. We concur with the Center for Capital Markets Competitiveness of the United States Chamber of Commerce which advised in its April 12, 2011 letter: "...the current proposal to amend Rule 4.5 was published in February 2011 in the middle of a partially completed avalanche of derivatives regulatory reform initiatives with *no consideration given to the potentially adverse consequences that the amendments could have on market liquidity* and, by extension, the broader economy."[4] If highly liquid futures products cannot be used as investment vehicles, the unintended consequences of forcing volume into alternative markets such as options and Exchange Traded Funds (ETFs) could have the effect of increasing volatility in markets where the regulators' goals have been to decrease volatility.

Regarding certain explicit costs associated with dual registration, the STA agrees with Gus Sauter, Chief Investment Officer of Vanguard who stated in that firm's April 12, 2011 comment letter: "Subjecting RICs to CFTC regulation will entail significant costs and additional regulatory burdens, including increased compliance and related personnel costs (to be borne by RIC shareholders), without any apparent additional benefit to such RICs, their shareholders or the public. For these reasons, we urge the CFTC not to make any changes to the Rule 4.5 exclusion for RICs."

It is extremely important to note that any additional costs imposed on RICs are costs imposed on pools of shareholders who are the individual investors. The negative impact of costs is exacerbated on smaller fund companies who have fewer resources to absorb the additional

[4] http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/CFTC%E2%80%99s-Rule-4.5-relating-to-commodity-pool-operator-4.12.2011.pdf

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costs associated with dual registration. We ask that research should be done to determine if a revision of Rule 4.5 creates a barrier of entry for new funds.

Also, to repeal the exemptions that otherwise would currently apply to such situations without extensively considering the long term ramifications of the change would most likely lead to unnecessary filings which would in turn increase costs to individual investors.

Beyond our request for a "joint advisory committee" to adequately study and fully vet the ramification of the suggested regulatory changes to Rule 4.5, we also recommend that the CFTC extend this comment period to allow the joint advisory committee to have the time to perform the detailed research and evaluation of these proposed revisions before the CFTC finalizes any changes in Rule 4.5 that would alter the existing exemptions.

Questions by the CFTC in the proposing release

In its proposed rule, the CFTC requested comment on five questions regarding the proposed changes to Rule 4.5. Two of the five questions concern the marketing of mutual funds. We feel those two marketing questions lie outside our particular expertise since as an organization of trading professionals STA feels it is best positioned to advise the Commission from an investment and trading perspective and not from the perspective of the selling or marketing mutual funds. But we do want to offer our views on three of the questions, specifically Nos. 2, 4 and 5 as follows:

--Question No. 2: The Commission asked for comment as to the particular types of funds that would be impacted by the proposed rule. STA believes that the repeal of the exemptions could have broad and far reaching effects on a large variety of mutual funds, perhaps in ways not contemplated or desired by the Commission. However, it is still not completely clear which

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specific types of funds might be impacted and to what degree. We reiterate the need for more analysis and research to understand the types of funds that the changes to Rule 4.5 would adversely affect and we urge the CFTC to more extensively research this question to better understand the range of potential adverse implications of these changes.

--Question No. 4: The Commission asks which rules and regulations are in conflict and how the CFTC and SEC could address the conflicts. Some ready examples of such conflicting rules include: rules as simple as CPOs being required to send monthly account statements vs. RICs who typically send account statements quarterly, and as complicated as how fees and fund strategies are communicated to shareholders. As noted above, ICI has identified 18 examples of differences between SEC and CFTC rules that would result from imposing dual registration under Rule 4.5. Notwithstanding these individual illustrations of conflicting rules, we urge both the CFTC and the SEC to see that the potential for dual registration potentially puts ***all*** the rules in conflict, leaving funds answering to two regulators. The result would force mutual fund companies to constantly monitor two sets of regulations that could potentially conflict with each other. We do not see any countervailing policy value benefitting the investing public from creating a situation in which mutual funds have two sets of regulations from two federal agencies.

--Question No. 5: The Commission asks for opinions regarding the "5% test" and whether the percentage should be higher or lower. We urge the CFTC to not impose any limitation at all and allow the current exemptions to stand as they are written without addition of a percentage test.

In closing, we urge the CFTC not to adopt the proposed amendment but rather to let the existing exemptions stand. We recommend that the comment period be extended and request

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a joint CFTC-SEC advisory committee be formed to study and vet proposed changes to Rule 4.5.

Dual registration, coupled with the lack of clarity in the rules as presented, would result in a burdensome cost to investment companies. These additional costs, whether arising from registering as a CPO or from monitoring the need to register as a CPO vis-a-vis the proposal's new criteria, would ultimately have to be passed through to the investors in the mutual fund. We do not see that incurring these costs translates into better protection of either mutual fund customers or the market as a whole compared to the existing regulatory regime which has worked very well to date. We do not believe the CFTC should "fix" a regulatory regime that has not been demonstrated to be broken.

The STA appreciates the opportunity to provide its comments on this important matter. We look forward to establishing a dialog with the CFTC on these and other critical regulatory changes of tremendous significance to the mutual fund industry and its customers.

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