CENTER FOR CAPITAL MARKETS COMPETITIVENESS
OF THE
UNITED STATES CHAMBER OF COMMERCE

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

Re: RIN number 3033–AD30 - CFTC Request for Comment Regarding Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (76 Fed. Reg. 7976)

Dear Mr. Stawick:

The U.S. Chamber of Commerce ("Chamber") is the world's largest business federation representing over three million companies of every size, sector, and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy. The CCMC appreciates the opportunity to provide input to the Commodity Futures Trading Commission's (the "Commission" or "CFTC") regarding the notice of proposed rulemaking to amend CFTC Rule 4.5, which, in pertinent part, excludes mutual funds from regulation as commodity pool operators.

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. We have significant concerns with the administrative process related to these proposed amendments. In particular, we believe that:

- The scope of the CFTC's rule proposal is too broad (*i.e.*, the entire mutual fund industry is subject to potential CFTC regulation in order to address an issue that is, by definition, limited to a handful of registered investment companies);
- The CFTC's administrative process does not afford the fund industry with an opportunity to realistically assess the costs, burdens and impact of such amendments; and

- The CFTC's proposal does not give adequate consideration to the adverse effects on the mutual fund industry or the financial markets more generally that could result if the legitimate use of futures contracts by the entire mutual fund industry is restricted in the manner proposed.

Accordingly, we believe that the proposed amendments should be withdrawn or, at a minimum, any consideration of those amendments should be postponed until broader derivatives market regulatory reforms contemplated by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") have been completed in their entirety.

CFTC RULE 4.5: BACKGROUND AND THE PROPOSAL

The current form of CFTC Rule 4.5 has been in effect since 2003. In summary, this rule permits a registered investment company (also called a "mutual fund" or a "regulated fund") to avoid substantive regulation by the CFTC as a "commodity pool operator" ("CPO")[1]. There are two reasons to permit a regulated fund to avoid regulation as a CPO. First, every mutual fund is already subject to rigorous regulatory oversight by the Securities and Exchange Commission ("SEC"). A regulated fund is registered under the Investment Company Act of 1940 and must remain in compliance with the requirements of that law, including those that relate to disclosure, recordkeeping, and use of derivatives. Second, any additional oversight by the CFTC would expose the company to overlapping and possibly conflicting

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[1] Section 1a(5) of the Commodity Exchange Act defines a commodity pool operator as "any person engaged in a business that is of the nature of an investment trust...and who, in connection therewith, solicits, accepts or receives from others, funds...for the purpose of trading in any [exchange traded futures contract or option on such futures contract]".

regulatory requirements. If CFTC regulations governed a regulated fund, it might receive conflicting guidance as to permissible use of derivatives.

A regulated fund claims an exclusion from CPO regulation under Rule 4.5 by filing a notice of eligibility with the National Futures Association ("NFA"), the self-regulatory organization for the futures industry. As part of the requirements of this rule, the fund must provide prospective and existing shareholders with registration statement disclosure to the effect that it is not subject to regulation by the CFTC as a "commodity pool operator."

In February 2011, the CFTC proposed an amendment to Rule 4.5 that would impose two restrictions on the use of futures by registered investment companies.[2] The first restriction is a marketing restriction. The marketing restrictions states that the fund may not market itself as a commodity pool or otherwise as a vehicle for trading in (or otherwise seeking investment exposure to) the commodity futures or commodity options markets. The second restriction is in the form of what some market participants refer to as "the 5% Test". The 5% Test does not restrict a regulated fund's use of commodity futures or commodity options contracts solely for "bona fide hedging" purposes (defined in CFTC Rule 1.3(z), generally, as risk reducing transactions). However, the 5% Test does restrict the regulated fund's use of such futures or options for non-bona fide hedging positions: the aggregate initial margin and premiums required to establish such positions must not exceed five percent of the regulated fund's net asset value, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into. Both of these restrictions were in place under the prior version of Rule 4.5 for the period from 1993 to 2003, 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."[3]

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[2] The NFA's petition to the CFTC can be accessed at http://www.nfa.futures.org/news/newsPetition.asp?ArticleID=3630.

[3] *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).

CONCERNS WITH THE ADMINISTRATIVE PROCESS

The CCMC has several concerns with the manner in which the rulemaking process in respect of the Rule 4.5 proposals is being carried out by the CFTC.

The Proposed Rule is Too Broad

The CCMC is concerned that the proposed rule is too broad. The amendment to Rule 4.5 will affect the *entire* mutual fund industry despite the fact that both the NFA petition and the CFTC proposal raise concerns with "*certain* registered investment companies."[4]

> *According to the February 11th rule proposal, the amendments to Rule 4.5 have been proposed in order "[t]o stop the practice of registered investment companies offering futures-only investment products without commission oversight."*[5]

While we understand that concern, we do not believe that the proposed amendments—which impose prophylactic limitations on the use of derivatives by *any* regulated fund—are reasonable in scope or application. Simply put, a reasonable approach to address the concern would be to address futures-only funds in a surgical manner or, in the alternative, to draw the line somewhere between the 5% Test and a futures-only fund. From an administrative process perspective, the CFTC has not given any consideration to a more reasonable approach.

Consideration of the Proposed Rule At This Time Is Not Realistic

We also have serious reservations that *any* proposal to amend CFTC Rule 4.5 at this time is not a realistic undertaking. The regulated fund industry cannot assess the costs, burdens and impact of the proposed amendments to CFTC Rule 4.5, since a

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[4] *Commodity Pool Operators and Commodity Trading Advisors: Amendment to Compliance Obligations*, 75 FR 7976, 7983 (February 11, 2011); see also the NFA petition, which identified only three specific funds out of the entire mutual fund industry.

[5] 75 FR at 7984.

proper understanding of the effect of the restrictions is predicated upon the promulgation of rules by the CFTC, the SEC and the Federal banking regulators under Title VII of the Dodd-Frank Act.

In July 2011, the definition of a CPO will be expanded to cover both futures and swaps (*i.e.*, both exchange-traded and over-the-counter ("OTC") derivatives. This expansion represents a major change to the regulation of derivatives that, in turn, necessitates a complete overhaul of the administrative rules that apply to the derivatives markets. Until the new derivatives rules are finalized, the mutual fund industry cannot possibly understand the effects of the proposed amendments to Rule 4.5 (which are *not* mandated by Dodd-Frank). By way of example, we note the following three illustrative situations:

- First, the 5% Test will only apply to margin in respect of futures positions that are not held for "bona fide hedging purposes," a term that is defined by reference to CFTC Rule 1.3(z). As part of the Dodd-Frank Act's overhaul of the derivatives markets, Congress has mandated that the CFTC more narrowly define which transactions will qualify as bona fide hedges.

  > *Indeed, in the February 11th rule proposal, the CFTC stated, "The revisions to [Rule] 4.5 herein contain a reference to the definition of "bona fide hedging" as it is currently set forth in [Rule] 1.3(z) of the Commission's regulations. The Commission notes that rules proposed in the futures regarding "bona fide hedging" may require the proposed revisions to be amended to reflect such new regulations."*

  Until there is certainty with respect to the issue of what does or does not constitute a bona fide hedge under CFTC Rule 1.3(z), the regulated funds industry has no way of understanding what effect the 5% Test may have on the management of registered investment companies.

- Second, as proposed, the 5% Test will only apply to initial margin on futures contracts and options on futures contracts. However, in its proposing release, the CFTC raised the specter of the application of the Rule 4.5 to swaps and, by

extension, margin on swaps.[6] Such an extension is extremely problematic since the CFTC and the SEC have yet to propose margin requirements in respect of swaps and security-based swaps, respectively.

> *As explained by CFTC Chairman Gary Gensler in a March 16th speech, "Key amongst the proposed rules that we still need to consider are three that require significant coordination with our fellow regulators: capital and margin."*[7]

Until swap margin requirements are determined by the regulators, the regulated funds industry cannot realistically assess whether or not Rule 4.5 should be expanded to cover swaps.

- Third, the regulated funds currently use OTC currency forwards and OTC currency options on a relatively interchangeable basis with any decision as to one type of derivative over the other made on the basis of what is most efficient for the particular portfolio of investments under management. Under Title VII, the Secretary of the Treasury has the ability (but is not required) to determine whether to exempt currency forwards—but not currency options—from the central clearing mandate, the keystone of the market reform initiatives in Dodd-Frank. Such an exemption could have a significant effect on margin levels, if the margin for OTC forwards differs from the margin OTC currency options. Again, any ambiguity with respect to margin levels makes it impossible to understand the effect of the proposed rules on the regulated funds industry.

The February 11th rule proposal does not give any consideration to these issues or the more general concern that the mutual fund industry can not possibly understand the effects of the proposed amendments to Rule 4.5 until all of the Congressionally mandated reforms called for by Title VII have been implemented.

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[6] 75 FR at 7984; "Should the calculation of the limit include swaps, or be limited to futures or options?"

[7] *Remarks, Implementing the Dodd-Frank Act, FIA's Annual International Futures Industry Conference, Boca Raton, Florida*, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-73.html.

Inadequate Consideration to Effects on the Fund Industry or Broader Economy

Finally, CCMC is concerned that adequate consideration has not been given to the effects of the proposed rule on the regulated funds industry or the financial markets. By way of background, the current version of Rule 4.5 was adopted after thoughtful consideration was given to the benefits of providing registered investment companies with less restricted access to the futures markets. The following is an overview of the timeline in respect of the implementation of the current form of Rule 4.5:

- September 2002: CFTC held a Roundtable on CPO and CTA issues, including the removal of the 5% Test and Marketing Restriction from Rule 4.5.

- November 2002: CFTC issues an Advanced Notice of Proposed Rulemaking in respect of the removal of the 5% Test and Marketing Restriction from Rule 4.5.

- March 2003: CFTC proposes amendments to Rule 4.5 that would remove 5% Test and Marketing Restriction from Rule 4.5, so as to liberalize the use of futures by regulated funds, ***"with the added benefit to all market participants of increased liquidity."*** [8]

- August 2003: CFTC adopts Rule 4.5 in its current form.

By comparison, 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. Admittedly, the CFTC provided the public with notice of the NFA's petition in September 2010 and sought comments from the

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

public in respect of that petition.[9] However, the CFTC does not appear to have given substantial consideration to the nearly 20 letters received in response to the September 2010 notice.

> *Indeed, in the February 11th rule proposal, the CFTC expressed its belief that "the NFA's proposed language is an appropriate point at which to begin discussions regarding the Commission's concerns."*[10]

Consistent with the practice of the CFTC in the most recent amendments to Rule 4.5 in 2003, the CCMC believes that a roundtable coupled with an advance notice of proposed rulemaking is the appropriate administrative process for this type of a significant rule proposal.

In conclusion, we understand the desire of the CFTC's concerns that relate to the offering of futures-only regulated funds without any oversight by the CFTC. However, we do not believe that it is appropriate to disrupt an entire industry when more surgical, tactical rulemaking initiatives will suffice. Furthermore, as described above, we have significant concerns with the administrative process surrounding the proposed amendments to CFTC Rule 4.5 and, at a minimum, believe that prudence dictates that the CFTC postpone any further actions in respect of this rule until all relevant aspects of the derivatives market regulatory reform are known and all required final rules are promulgated.

Sincerely,

David Hirschmann

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[9] *Petition of the National Futures Association, Pursuant to Rule 13.2, to the U.S. Commodity Futures Trading Commission To Amend of the Rule 4.5*, 75 FR 56997 (September 17, 2010).

[10] 75 FR at 7984.