WRITTEN STATEMENT

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FOR THE JOINT MEETING ON

HARMONIZATION OF REGULATION

BEFORE THE

COMMODITY FUTURES TRADING COMMISSION

AND

SECURITIES AND EXCHANGE COMMISSION

SEPTEMBER 3, 2009

Good morning, Chairman Gensler, Chairman Shapiro, and Commissioners of the CFTC and of the SEC. I am Kathleen Moriarty, a partner at the law firm of Katten Muchin Rosenman LLP and I thank you for this opportunity to speak before you today. As I have spent my entire professional life in private practice representing market participants who design and offer financial products to the investing public, I work closely with regulated entities and their regulators. My area of expertise is structuring and representing registered investment vehicles that issue securities offered to retail as well as sophisticated clients, such as exchange-traded investment companies ("ETFs"), exchange-traded vehicles investing in commodities ("ETCs"), unit investment trusts ("UITs") and mutual funds. As a result, I am often presented with legal and business issues occasioned by the desire of these funds to hold a mix of securities and commodities in their portfolios.

Convergence and Cross-Fertilization between the Commodities and Securities Markets

Over the past twenty-five years, much of the innovation in financial products has occurred because improved technology has yielded better and faster dissemination of data and information about individual products as well as the markets overall, provided more transparent pricing and permitted increased efficiencies in clearing and settlement, to name but a few benefits. In addition, partly as a result of the demise of the company provided pension fund, this technology helped inform individual investors that other investments existed beyond bank CDs and stocks. Many retail investors were persuaded by advocates of indexing, such as John Bogle, about the benefits of portfolio diversification and a disciplined investment approach investment coupled with a long term buy and hold strategy. Individual investors who did not have the wherewithal to efficiently construct and manage a diversified portfolio found that indexed mutual funds provided an economically attractive arrangement. Today, more than a third of US households own shares in mutual funds.

Focus on portfolio diversification led to a growing awareness of alternative investments, and investors began to take an interest in commodities, partly due to the belief that it was prudent for a well-rounded portfolio to have at least a small percentage held in non-correlating assets. This marked a paradigm shift, because many investors cannot, or do not, participate directly in the commodities markets. Institutions, such as public and private pension funds, are often prohibited by enabling legislation, statutes or organizational documents, from owning commodities outright. Other institutional investors, as well as individuals, do not participate because they are unfamiliar with the operation of the commodities markets, are concerned about the risks of leverage, or worry that they may have to take actual delivery of pork bellies. Today, however, more of these investors gain exposure to commodities through pooled vehicles; they, like mutual fund shareholders, have discovered the efficiencies and economic benefits offered by these products. Further, investors purchasing the equity securities issued by these pooled commodities vehicles understand the operation and processes of the equity market and are comfortable transacting in their brokerage account with their customary investment professionals. In addition, certain investor concerns about holding commodities outright may be alleviated or eliminated when held in pooled form. Examples include the precious metal ETCs such as SPDR Gold Trust and ETFS Silver Trust which hold physical gold and silver, respectively, in bullion form, thus eliminating both leverage and local delivery and storage concerns.

This cross-fertilization between the commodities and securities markets can be readily observed in the design of the SPDR Trust, the first US ETF. The inventor of the product, Nate Most, was a physicist and engineer by training, an agricultural commodities trader by profession and president of the Pacific Commodities Exchange. Later, when tasked with creating a new equity trading product for the American Stock Exchange, Nate applied his commodities knowledge to the design process. He first took the stock indexing concept and selected the S&P 500 for use in a broadly diversified pooled vehicle, then added the price and speed efficiencies of securities program or basket trading (available at that time only to very large institutions) and grafted these features onto the commodities negotiable warehouse receipt model. Therefore, he viewed each of the S&P 500 stocks as a "physical" asset, and the entire group of the 500 stocks, a "Basket", as fungible; that is, Baskets were interchangeable at equal value, just as if they were barrels of WTI crude or other physical commodities. Further, Nate used the commodities concept of "EFP" (exchange for physical) in designing the standard delivery mechanism for Baskets; this allowed the custodian of the pooled vehicle to receive all of the 500 stock components of a Basket "in kind" rather than accept cash which would then be used to purchase such stocks. This in-kind design worked in reverse for redemptions.

Nate also realized that each Basket could be passively held by the custodian just as if it were "stored" in a warehouse. Continuing the analogy, therefore, a person delivering one or more Baskets to the custodian would receive a "receipt"- a Standard and Poor's Depositary Trust Receipt or "SPDR", which would be listed and traded on the Amex. The "receipt" permitted its owner to store the Baskets with the custodian upon certain conditions and the payment of fees until such time as the owner tendered the receipt for redemption, whereupon the custodian would cancel the receipt and deliver the Baskets back to the owner. Given that the cost of a single Basket was in excess of one million dollars, and that the Amex wanted a product designed for retail investors, the product design called for the receipt to be "burst" immediately upon issuance into fractional undivided interests of 50,000 individual SPDRS for trading in the secondary market on the exchange, like any other exchange-traded equity security. These exchange-traded securities were not individually redeemable, but when assembled into one or more aggregations of 50,000, they could be redeemed to the custodian in exchange for the corresponding number of Baskets. This structural feature permitted the SPDR Trust's portfolio of the S&P 500 stocks to expand or shrink in size according to market demand for SPDRs and provided an efficient arbitrage mechanism to keep the SPDR prices trading on the market close to the net asset value of a Basket.

Of course, the warehouse receipt and other commodities features had to be translated into a securities product. Any pooled vehicle holding Baskets comprised of stocks and issuing equity securities (SPDRs) for sale to the public was by definition an "investment company" under the Investment Company Act of 1940 (1940 Act) required to register with the SEC as such. The SPDR design, however, was unlawful because it was a hybrid of different types of investment companies permitted under the 1940 Act and not expressly permitted by the statute. That is, the SPDR Trust's ability to issue an unlimited number of SPDRs and redeem them at net asset value were the hallmark features of a UIT or open-end investment company, while its ability to list SPDRS for trading in the secondary market was the hallmark feature of a closed-end fund. A discussion of the exemptive and other regulatory relief necessary to bring this non-conforming product to market is for another day, but the SEC granted the requested relief which set the precedent for ETFs to follow. Despite the fact that it can take a long time to request and receive an exemptive order under the 1940 Act, I believe that the flexibility provided to the SEC under section 6(c), in particular, has permitted a great deal of product innovation and is a statutory mechanism that permits the approval of products and arrangements that were unforeseen when the statute was adopted. The exchange listing and arbitrage mechanism inherent in the SPDR design proved to be very popular, and the ETF industry was born. As noted above, it was only a matter of time before the ETF design came full circle when product designers began to create ETCs for sale to retail investors.

Commodities Exposure Provided by Current Pooled Vehicles to Retail Investors

Today, there are four main types of pooled vehicles which offer retail investors exposure to commodities, ranging from a small amount up to one hundred percent exposure. These are: open-end and closed-end investment companies, ETFs, publicly traded commodity pools, and ETCs. However, open-end and closed-end investment companies, as well as ETFs, are inherently limited in providing significant commodity exposure because each is an investment company governed and regulated by the 1940 Act. The 1940 Act, its rules, and certain staff interpretations impose a variety of restrictions on portfolio investments in commodities made by open-end and closed end funds and ETFs.

Most importantly, commodities are not "securities" as defined under the 1940 Act and therefore investment companies cannot hold or trade a portfolio comprised entirely or principally of commodities. Secondly, commodity contracts are treated as "senior securities" under section 18 of the 1940 Act which imposes strict limits on the amount of permissible leverage, as well as asset coverage requirements. In addition, many commodities fall short of the liquidity standards necessary for open-end funds' and ETFs' compliance with section 22(e) of the 1940 Act which requires that redemption proceeds in most cases be paid no later than seven days after tender for redemption. Further, most investment companies registered with the SEC under the 1940 Act rely upon Subchapter M of the US Internal Revenue Code for important tax "pass-through" treatment. Subchapter M also contains prohibitions and limitations with respect to commodities, for example, commodities contracts do not produce "qualifying income".

First Generation ETCs

Given these regulatory restrictions, product designers wishing to offer retail investors greater or more concentrated exposure to commodities than can be had through investment companies have turned to ETCs. These are sometimes also referred to as "commodity ETFs" which has caused a degree of marketplace confusion because it suggests that certain exchange- traded investment companies have managed to evade all of the 1940 Act and Subchapter M requirements discussed above. The first generation of ETCs were organized as common law trusts that received, held and delivered precious metal outright in stated large size aggregations and issued securities in small size denominations that traded on a stock exchange. These trusts held no futures contracts but only metal (and sometimes a small amount of cash to pay expenses) and therefore were not regulated by the CFTC as publicly traded commodity pools; however, their securities were registered with the SEC under the Securities Act of 1933 ("1933 Act"), as well as listed and traded on stock exchanges and accordingly registered under the Securities Exchange Act of 1934 ("1934 Act"). Therefore, the trading mechanisms and tools available to investors of the securities issued by ETCs were identical to those of their ETF counterparts; that is, they were held in brokerage accounts, subject to the same margin requirements and available order formats (*e.g*. stop loss and limit orders). Another feature important to many investors was that the ETCs did not engage in leverage and therefore, the risk of loss was limited to the amount originally invested. Note that these ETCs were structured as grantor trusts to achieve tax pass-through treatment as they could not rely upon the provisions of Subchapter M because they were not registered investment companies. A grantor trust, among other things, is an extremely passive structure and permits no management. However, this was not seen to be a design defect for the precious metals trusts which were unmanaged.

Next Generation ETCs

Spurred on by the enthusiastic investor reception given to the precious metal ETCs, product designers turned to other commodities of interest to retail investors who had shied away from outright investment in futures. Energy products, such as crude oil, natural gas and heating oil, as well as agricultural products such as corn, wheat, and soy beans were offered. Retail investors are now provided the opportunity to use a variety of commodities for hedging and other risk mitigation tools that previously were unavailable. Recent action by the CFTC with respect to the imposition of position limits on several energy-related ETCs has interrupted the arbitrage mechanisms of these pools; new shares can not be issued because new energy futures cannot be deposited into their portfolios. This imbalance in the supply and demand for these ETC shares has caused their price to deviate from the net asset value of their underlying assets. Both institutional and retail investors have expressed concern with respect to position limits on the underlying energy contracts and their deleterious impact on ETC pricing, and I would urge the CTFC to consider the recommendations made by John Hyland[1] with respect to the grant of bona fide hedging exemptions to ETCs.

[1] See, Testimony Of John Hyland Before The Commodities Futures Trading Commission Concerning Energy Position Limits and Hedge Exemptions, August 5, 2009 at: http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/hearing080509_hyland.pdf

Suggested Areas For Harmonization

I believe that a merger between the CFTC and the SEC is highly unlikely to occur in my lifetime. I agree with the panelists yesterday who felt that there were certain differences between commodities and securities that justified, or even necessitated, disparate treatment and that that the operative principle for harmonization should be equal treatment for similar products. Therefore, I endorse the concepts of joint compliance examinations and joint registration of investment professionals, understanding that the "plumbing" may be complicated and that the devil is in the details.

I believe that the intertwined goals of investor protection and education are of paramount importance in the area of pooled investment vehicles that are offered to the public. Just as commodities pose risks and issues different than those for securities, it is also the case that investments pooled together for the benefit of one group but managed by others provide opportunities for abuse, conflicts of interest, self dealing and other problems. In a "perfect world", I would like to see all such financial products primarily regulated by a single agency and I believe that that they are well understood by the SEC and its Division of Investment Management which is charged with the "oversight and regulation of America's $26 trillion investment management industry"[2]. Arriving at this result in a perfectly coherent and elegant manner would require coordinated changes to both commodities and securities laws, something else unlikely to happen in my lifetime.

In preparing for this panel, I have found it a novel experience to think of ways to promote harmonization between our two regulatory systems rather than methods of coping with the existing structures. Therefore, in the spirit of harmonization between two regulators, I offer a radical suggestion and apologize that I cannot yet provide a detailed roadmap for implementation. I believe that the 1940 Act and its related rules and interpretations is the existing statute best suited to review and regulate pooled vehicles, and their portfolio assets and transactions. Although, as discussed earlier, the 1940 Act clearly excludes commodities from the definition of securities that can be held by an investment company, there is no express prohibition against including commodities in the portfolio of an investment company. Assuming for the purposes of this discussion that the that statutory definitions of "securities" and "investment company are not amended, could we not proceed via the existing exemptive order mechanism to create a series of approved ETC designs. Section 6(c) is very broad and flexible; under appropriate circumstances, it can be used to waive all provisions of the 1940 Act. That would not be necessary in this case, only modifications to various existing procedures

[2] http://www.sec.gov/about/whatwedo.shtml#org

would be required.[3] If this were to happen, all pooled investment vehicles offered to the general public, regardless of their portfolio assets, would be subject to the same regulatory regime, provide similar and comparable disclosure documents, utilize advisers and financial advisers with fiduciary obligations to their clients and would be subject to review by regulators attuned to the peculiarities and possibilities for abuse presented by such portfolio entities. I realize that using the exemption order process in this manner would, in effect, result in an "inclusion" order, but the Division of Investment management and the Commission have proved willing to consider unusual structures and arrangements under Section 6(c) that meet the statutory requirements. One of the great things about practicing in the 1940 Act arena is that it provides opportunity to be creative for the benefit of the investing public and the financial markets.

I welcome the opportunity to answer any questions.

[3] I am not making any recommendations with respect to Subchapter M amendments or modifications as that is beyond my expertise. However, I note that ETCs currently cannot elect RIC status under Subchapter M, so the fact that RIC status might continue to be unavailable to ETCs registered as investment companies would not disadvantage investors.