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January 11, 2011

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

Re: Exemption from Position Limits for Diversified Funds

Dear Mr. Stawick:

The Investment Company Institute¹ appreciates the opportunity to provide the Commodity Futures Trading Commission (“CFTC”) with comments regarding position limits in advance of this week’s meeting to consider issuance of a proposed rule pursuant to Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”). As investors in the futures and swaps markets, registered investment companies (“RICs”) support the important objectives of preventing market manipulation and sudden price fluctuations in the commodity markets. Imposing position limits, however, on RICs that invest in futures contracts or fully collateralized swaps in various commodities to replicate the performance of commodity indices is unlikely to advance these goals and may, in fact, undermine them. Further, as discussed below, position limits, if not carefully crafted, could have an adverse impact on certain RIC investors. We therefore recommend that the CFTC establish an exemption from position limits for diversified RICs that comply with the leverage requirements of the Investment Company Act of 1940 (“Investment Company Act”) and that take passive, long-only positions (“diversified funds”).

I. Exemption for Diversified Funds

The Institute believes an exemption for diversified funds is permitted under Section 737 of the Dodd-Frank Act, which requires the CFTC to set position limits “as appropriate” across all markets. That section also authorizes the CFTC to “...exempt, conditionally or unconditionally, any person or class of persons...from any requirement it may establish under this section with respect to position

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.31 trillion and serve over 90 million shareholders.

limits.” This exemptive authority is reinforced by the legislative process. In a Senate floor statement on July 15, 2010, then Agriculture Committee Chairman Blanche Lincoln said:

In implementing section 737, I would encourage the CFTC to give due consideration to trading activity that is unleveraged or fully collateralized, solely exchange-traded, fully transparent, clearinghouse guaranteed, and poses no systemic risk to the clearing system. This type of trading activity is distinguishable from highly leveraged swaps trading, which not only poses systemic risk absent the proper safeguards that an exchange traded, cleared system provides, but also may distort price discovery.

In addition, Congressman Spencer Bachus, Ranking Member of the House Committee on Financial Services, and Congressman Frank Lucas, Ranking Member of the House Committee on Agriculture, wrote a letter to financial regulators stating their hope that regulators would use their exemptive authority to “avoid establishing position limits which would force widely-held funds or firms to divest their current holdings in highly regulated products.”² Taken together, we believe the provisions of Section 737 of the Dodd-Frank Act and sentiments of Congress would allow the CFTC to exempt diversified funds from any position limit requirements that it determines to adopt pursuant to Section 737.

A. Role of Diversified Funds

Diversified funds play an important role in the futures and swaps markets. They serve as a stable, long-term source of liquidity and facilitate efficient price discovery in these markets. Diversified funds are not speculators but rather are long-term investors. They provide small investors with access to the commodities market that may not otherwise be available to them. Consequently, in addition to providing significant benefits to the futures and swaps markets, diversified funds also provide small investors with a cost-effective means of investing in the commodity markets that may provide important portfolio diversification, inflation hedging, and risk mitigation benefits.

Diversified funds that invest in the futures and swaps markets are investing on a long-term basis to replicate the return in these markets and should be distinguished from speculators. Diversified funds do not selectively target particular physical commodities or amass significant positions in any one commodity, like silver or oil, such that their selling decisions could affect market pricing. Rather, these funds invest in a diversified basket of commodities, without focusing on any particular market. Additionally, many of these funds do not hold positions in the delivery month, which reduces their

² See Letter from Congressman Spencer Bachus (R-AL), Ranking Member, House Committee on Financial Services, and Congressman Frank Lucas (R-OK), Ranking Member, House Committee on Agriculture, to Timothy Geithner, Secretary, The Department of the Treasury, Mary Schapiro, Chairman, Securities and Exchange Commission, Gary Gensler, Chairman, Commodity Futures Trading Commission, and Ben Bernanke, Chairman, Federal Reserve, dated December 16, 2010. See also, Letter from Senator Blanche L. Lincoln, Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, to Gary Gensler, Chairman, Commodity Futures Trading Commission, dated December 16, 2010.

possible impact on price convergence during the time when concerns over price volatility have traditionally been the greatest. Further, because of the nature of these funds that seek to track the return of a commodity index, their trading represents liquidity and market depth, which might not be the case for an individual market speculator that actively trades in and out of the market.

Position limits are often justified on the grounds that more diffuse investment in the commodity markets will reduce the likelihood that one trader holding a substantial position will be able to unduly influence the price of any one commodity. This rationale, however, does not apply to diversified funds that aim to mirror the performance of the underlying commodity markets by benchmarking to an index. These funds merely represent the investment decisions of individual market participants. The size of their positions is largely determined by individual investors moving in and out of the fund rather than an independent, active investment strategy, meaning changes in positions typically occur in small amounts versus large volatile swings. As such, these funds are no more likely or capable of engaging in price manipulation than the individual investors themselves.

Yet, imposing position limits on diversified funds could harm the futures and swaps markets as well as fund investors in those markets. Position limits could reduce the liquidity available to commodity producers and end-users who rely on these funds to take the other side of their trades. By reducing liquidity, price discovery would be impaired as well. Fewer traders, and consequently transactions, in the commodities derivatives markets would result in less transparency and information to identify the true market price of a contract. The imposition of position limits would also impair an important portfolio diversification tool for fund investors.

B. Stringent Regulation of Diversified Funds

Diversified funds are registered under the Investment Company Act, which imposes stringent regulation on RICs that is not imposed on other financial institutions or products under the federal securities laws. These measures prevent excessive speculation and market manipulation and ensure that diversified funds do not contribute to systemic risk and are not too heavily concentrated in one investment. We believe the rigorous regulatory regime imposed on diversified funds by the Investment Company Act provides an additional justification for different treatment – *i.e.*, an exemption – for these specific funds under any position limit rules adopted by the CFTC.

For example, RICs are subject to significant limitations on their ability to use leverage, limiting their ability to cause or contribute to systemic risk. Specifically, under Section 18 of the Investment Company Act and later Securities and Exchange Commission (“SEC”) and staff guidance, a RIC is prohibited from taking on a future obligation to pay unless it “covers” the obligation by setting aside, or

earmarking, assets sufficient to satisfy the potential exposure from the derivative transaction.³ The assets used for “covering” such obligations must be liquid, marked to market daily, and held in custody.⁴

The custody requirements for the safeguarding of RICs’ investment securities are found under Section 17(f) of the Investment Company Act. RICs must “place and maintain” their assets in the custody of a bank, or subject to certain SEC rules, a member of a national securities exchange or the fund itself.⁵ In particular, Rule 17f-6 under the Investment Company Act explains how assets should be maintained in connection with commodity derivatives contracts.

In addition, RICs are subject to limits on exposure to certain counterparties. Under Section 12(d)(3), RICs’ investments in securities of securities-related businesses are subject to certain percentage limitations. Because derivatives counterparties are typically securities-related business, many RICs interpret this section as imposing a 5 percent limit on the RIC’s total assets that may be invested in derivatives with any single counterparty. Further, RICs electing to be “diversified companies” under the Investment Company Act must invest at least 75 percent of total assets in cash and securities and, within this 75 percent of assets, may not invest more than 5 percent of total capital in any single issuer.⁶

Additionally, RICs are subject to rigorous disclosure requirements, including disclosure of their investment objectives and policies, the concentration of investments in any particular asset class or industry, and their net asset values. Finally, RICs are obligated to maintain comprehensive compliance programs to ensure that all of these obligations are fully met to protect investors and the markets.

II. Aggregation Unnecessary and Inappropriate

If the CFTC determines not to provide an exemption for diversified funds, as discussed above, we recommend that it permit disaggregation among these funds.⁷ Specifically, in calculating positions under any rules adopted by the CFTC, advisers should report the positions of each of their clients

³ See Rule 18f-3 under the Investment Company Act of 1940. Under certain circumstances, a RIC may also enter into transactions that offset the RIC’s obligations. See Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) 48,525 (June 22, 1987).

⁴ See Merrill Lynch Asset Management, L.P., SEC No-Action Letter, 1996 WL 429027 (July 2, 1996) and Investment Company Act Release No. 10666 (April 18, 1979), 44 FR 25128 (April 27, 1979).

⁵ As a practical matter, this option is rarely used; most RIC assets are maintained with a bank custodian.

⁶ See Section 5 of the Investment Company Act of 1940.

⁷ In the same Senate floor statement discussed above, then Agricultural Committee Chairman Blanche Lincoln said, “Further, I would encourage the CFTC to consider whether it is appropriate to aggregate the positions of entities advised by the same advisor where such entities have different and systematically determined investment objectives.”

separately and should not be required to aggregate the positions of any fund with the positions of other funds managed by the same adviser or its affiliates. The size of a diversified fund's positions typically is not controlled by the sponsor but by the investors that move into and out of the fund so coordination between funds for purposes of manipulation and speculation is inapposite. Moreover, each fund is a separate client of a registered investment adviser, with a separate group of investors and independent investment objectives.⁸ As a fiduciary, advisers to these funds must make decisions based on the objectives and needs of each individual diversified fund without taking into account other diversified funds' positions. Accordingly, there is no reason to believe that diversified funds managed by the same adviser or its affiliates would inappropriately engage in manipulative trading activity.

Furthermore, we believe that the Commission should maintain its independent account controller exemption under existing CFTC regulations.⁹ To eliminate this exemption would be to disregard the import safeguards that fund managers have established to prevent inappropriate sharing of information. It could also create potential conflicts of interest that these safeguards have been designed to eliminate.

III. Definition of Bona Fide Hedging

We recognize that the Dodd-Frank Act instructs the CFTC to exempt "bona fide hedging" transactions from position limits. We urge the CFTC to define "bona fide hedging" as it is commonly understood in the investment industry and adopt a definition that encompasses both commercial and financial hedging. Investors rely on funds to hedge their portfolio risk, including inflation and currency risks. Rather than adopt an overly restrictive definition of "bona fide hedging," we recommend that the CFTC include these risk-reducing transactions within the definition of "bona fide hedging."

IV. Position Points Inappropriate

The CFTC has recently discussed the implementation of a "position points" regime that would be implemented as an interim measure until the CFTC has gathered data to fully implement position limits. The "position points" concept would require the CFTC staff to exercise heightened surveillance of large positions and would give the CFTC discretion to take action to limit the size of positions any market participant could hold if it exceeds the "position point," as determined by a majority of the Commission. We are unaware of the legal authority for such CFTC discretion. Absent a notice and comment rulemaking process similar to the one the CFTC is proposing to undertake for position

⁸ With a few exceptions, the marketplace and the Securities and Exchange Commission apply the provisions of the federal securities acts to funds at the individual entity level, treating individual funds and series funds as if the separate portfolios were separate investment companies. *See* Legal Considerations in Forming a Mutual Fund, Philip H. Newman, ALI-ABA Course Materials, June 2010.

⁹ *See* CFTC Rule 150.3(a)(4) (providing an exemption from aggregating positions of separate funds when trading is controlled by independent decision-makers).

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limits, we question whether there is sufficient authority to enforce “position points.” Furthermore, we are concerned that the criteria for when the CFTC may elect to enforce “position points” is vague and uncertain. Such uncertainty could adversely affect market participants’ interest in participating in the futures and swaps markets, thereby reducing market liquidity, and the potentially arbitrary application of the “position points” to individual market participants could be subject to challenge. In addition, the use of “position points” by the CFTC would minimize the ability of exchanges to offer guidance in these important matters affecting market functioning and liquidity. We strongly urge the Commission to refrain from exercising enforcement of “position points” without providing the public an opportunity to provide input.

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If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815, Heather Traeger at (202) 326-5920, or Ari Burstein at (202) 371-5408.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: The Honorable Gary Gensler, Chairman
The Honorable Michael V. Dunn, Commissioner
The Honorable Jill E. Sommers, Commissioner
The Honorable Bart Chilton, Commissioner
The Honorable Scott D. O’Malia, Commissioner