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COMMENT

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Concept Release on Whether to Eliminate the *Bona Fide* Hedge Exemption for Certain Swap Dealers and Create a New Limited Risk Management Exemption from Speculative Position Limits

Dear Mr. Stawick:

The Investment Company Institute[1] welcomes the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC") concept release on whether to eliminate the *bona fide* hedge exemption for certain swap dealers and to create a new limited risk management exemption from speculative position limits.[2] Registered investment companies invest in the U.S. commodities markets through various types of commodity-based instruments, including commodity linked swaps. In turn, many retail investors rely on commodity index funds, and other funds that invest in commodities, to obtain exposure to the commodities markets, which can help diversify an investor's portfolio and hedge against inflation. We therefore support the CFTC's efforts to examine and address concerns in this area[3] and to better understand the possible elimination of the swap dealer hedge exemption through issuance of the Concept Release prior to proposing and adopting any new rules.

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[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 $10.18 trillion and serve over 93 million shareholders.

[2] *See Concept Release on Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and Create a New Limited Risk Management Exemption From Speculative Position Limits*, 74 Fed. Reg. 12282 (March 24, 2009) ("Concept Release").

[3] *See, e.g., Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations*, Commodity Futures Trading Commission, September 2008 ("2008 Report").

We support efforts to address any abusive practices in this area to ensure that the U.S. commodities markets remain fair, liquid, and competitive. However, given the lack of empirical evidence to support the elimination of the exemption and the potential unintended consequences of such an action, we strongly urge the CFTC to retain the *bona fide* hedge exemption for swap dealers. Our specific comments are discussed below.

I. Commodity Index Funds

Commodities provide several benefits to investors – they can help hedge against inflation, diversify an investor's portfolio, and provide a buffer against downturns in stock and bond prices. For many investors, one of the most cost-effective and practical means of gaining access to the commodities markets is through funds such as commodity index funds.[4] Commodity index funds are passively managed investment vehicles designed to track the performance of a broad commodity index and are designed to generate the return that an investor would achieve by directly holding a large basket of futures contracts on a fully collateralized basis. They operate without leverage – for every dollar of exposure, the investment company holds a dollar of collateral – and may gain exposure to commodities directly through the futures markets, or through other commodity-linked derivative instruments such as swap agreements, commodity index-linked notes, or commodity options.

Commodity index funds also serve an important and beneficial role to the commodities markets as a whole. By always holding long positions, commodity index funds consistently assume price risks that commodity producers, holders of commodity inventories, and other businesses seek to mitigate or eliminate. Commodity index funds also create liquidity in the market by buying long positions, selling futures contracts prior to maturity, and establishing new long positions with later maturities. Finally, because a commodity index fund invests according to an index and does not take the view that a particular commodity will go up or down in price, it should not be considered a "speculator." In this respect, the investment activity of a commodity index fund is highly distinguishable from the investment activity of discretionary commodity pools or other investment vehicles that may purchase and sell certain commodities based on their expectation of rising or falling prices, which may vary from time to time.

II. Retain Bona Fide Hedge Exemption for Swap Dealers

The Concept Release requests comment on whether swap dealers should no longer be allowed to qualify for exemption from the federal speculative position limits under the existing *bona fide* hedge definition and, if so, whether the CFTC should create a limited risk-management exemption based upon the nature of the swap dealer's clients. The limited risk management exemption would be

[4] While our comments focus on index investors such as commodity index funds, other funds often seek commodity index exposure as part of their investment portfolio and obtain such exposure through commodity index swap agreements. These funds would experience much of the same impact as commodity index funds from an elimination of the exemption.

conditioned upon, among other things, (1) an obligation to report to the CFTC and applicable self-regulatory organizations when certain noncommercial swap clients reach a certain position level and/or (2) a certification that none of a swap dealer's noncommercial swap clients exceed specified position limits in related exchange-regulated commodities.[5]

To enable swap dealers to hedge their economic exposure on swap transactions, the CFTC in 1991 began granting swap dealers *bona fide* hedge exemptions that permit them to exceed the federal speculative position limits, subject to specific limitations to protect the marketplace.[6] We believe that swap dealers should continue to qualify for exemption from the speculative position limits, and that such exemption should not be replaced with a limited risk management exemption based upon the nature of the swap dealer's clients. As discussed in further detail below, commodity index investors are not the cause of the CFTC's concerns regarding recent price increases and volatility in the commodities markets, eliminating the exemption would have a detrimental impact on commodity index funds and other funds, and the alternative limited risk management exemption would raise certain operational issues for funds.

A. Index Investors Not Cause of Commodity Price Increase and Volatility

The Concept Release and the 2008 Report indicate that one of the factors behind the CFTC's reconsideration of the *bona fide* hedge exemption for swap dealers is the concern that index traders may have been the cause of much of the price increase and volatility experienced last year in the commodities markets. We do not believe this assertion to be true.

A significant body of economic data and analysis indicates that the long-only activity of index traders was not the cause of the commodity price increases and volatility. Rather, the price increases and volatility were caused by factors relating the supply, demand and inventory in the physical markets for the commodities.[7]

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[5] The Concept Release also seeks comment on a number of other questions related to the general advisability of eliminating the existing exemption, and the specific scope and terms of the potential new limited risk management exemption.

[6] The limitations in the *bona fide* hedge exemptions for swap dealers include that (1) the futures positions must offset specific price risk; (2) the dollar value of the futures positions would be no greater than the dollar value of the underlying risk; and (3) the futures positions would not be carried into the spot month.

[7] *See, e.g., IMF World Economic Outlook*, International Monetary Fund, October 2008, *available at:* http://www.imf.org/external/pubs/ft/weo/2008/02/pdf/c3.pdf ("IMF Report"), at p. 83-93. The IMF Report found that the 2008 commodity price boom reflected the interaction of strong demand, low inventory and spare capacity levels, slow supply expansion in key sectors, and adverse supply shocks. It further concluded that, "Despite recent financial innovation in commodity markets, such as indexing, which has allowed investors to benefit from rising commodity prices without having to maintain physical inventory holdings, there is little discernible evidence that the buildup of related financial positions has systematically driven either prices for individual commodities or price formation more broadly." *See also Final*

Index investors, unlike many other commodity market participants, contribute minimally, if at all, to large or sudden flows of buying or selling pressures on a commodity. Most significantly, index investors are not driven by two key factors that can cause commodity price volatility: (1) a change in the expectation of what the future price of the commodity will be and (2) a change in the desire to be invested in a particular commodity. Specifically, because an index investor purchases and sells exposure to commodities based on a designated index and does not change its exposure to an individual commodity based on a predicted price, the expected future price of a commodity does not influence the trading behavior of an index investor. In addition, although the volume of index investment has recently increased, the volume of new investments remains small relative to the overall liquidity of the futures markets. The increased volume of index traders is, therefore, likely not a material contributing factor to the price volatility of a commodity due to increased desire.[8]

B. Detrimental Impact of Elimination of Exemption on Funds

The elimination of the *bona fide* hedge exemption and implementation of a limited risk management exemption would have a detrimental impact on commodity index funds and other funds. As described above, funds gain exposure to the commodities markets through various instruments, including commodity linked swaps entered into with a swap dealer. Such swaps have distinct advantages relative to futures contracts. Although futures markets offer investors a high degree of liquidity, futures contracts are more standardized and therefore may not meet the specific needs of the fund. In contrast, swaps offer investors flexibility because counterparties can tailor the terms of the contract to meet specific needs.[9]

If the CFTC eliminates the *bona fide* hedge exemption for swap dealers, this could significantly increase a fund's cost of entering into a swap transaction with a swap dealer because the dealer may not be able to adequately hedge its exposure. Further, swap dealers may significantly limit their willingness to enter into swap transactions and funds may be unable to locate other swap counterparties. As a result, funds may be unable to gain exposure to the commodities in the most optimal manner for the fund. This may increase the cost of investing in funds. In turn, investors simply may choose to

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Report of the Technical Committee of IOSCO, Task Force on Commodity Futures Markets, March 2009, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD285.pdf.

[8] For instance, the price of certain commodities not included in one of the four major commodity indices and without significant futures markets, such as iron ore and rice, experienced equal or greater appreciation in 2008 than the price of commodities with sizable futures markets and included on commodity indices. *See* IMF Report at p. 88-93. Also, as indicated in the 2008 Report, while crude oil prices were increasing in early 2008, index traders reduced their positions in crude oil. *See* 2008 Report at p. 4.

[9] *See* 2008 Report at p. 11.

abandon U.S. funds and markets where these restrictions or regulations apply, and invest in commodity funds and markets elsewhere. Moreover, because commodities are traded in global markets and global forces of supply and demand set the prices, efforts to restrict or regulate trading in the United States will not create a material change in commodity prices and may, in fact, have the opposite effect.

The limited risk management exemption also may have a detrimental impact on funds. This exemption would require swap dealers to "look through" the swap dealer to its counterparty traders and limit a fund's futures equivalent position based on the CFTC's speculative position limits. Under such an exemption, for example, the size of a commodity index fund could be dictated by the CFTC's speculative position limits. This would limit the ability of a fund to grow to its desired size, take advantage of economies of scale, and thereby operate in the best interest of its investors. Ultimately, investment advisers not yet offering commodity index funds may be reluctant to launch such funds, and those advisers already offering commodity index funds may determine to liquidate the funds.[10]

III. Specific Concerns with Limited Risk Management Exemption

The Concept Release contemplates that the limited risk management exemption would be conditioned upon, among other things, (1) an obligation to report to the CFTC and applicable self-regulatory organizations when certain noncommercial swap clients reach a certain position level and/or (2) a certification that none of a swap dealer's noncommercial swap clients exceed specified position limits in related exchange-regulated commodities. The Concept Release further indicates that the exemption may, in effect, require a swap dealer to "look through" to its counterparty traders for purposes of complying with the federal speculative position limits and restrict the position sizes of its counterparty traders. Imposing this requirement on swap dealers raises a number of operational and practical concerns.

First, requiring a commodity investor to provide a swap dealer with sensitive and proprietary information, such as details of all of the fund's commodity transactions, so that it may determine whether the swap counterparty has reached a designated limit, raises confidentiality concerns. The confidentiality of trading information is a critical issue to Institute members.[11] Sharing such information with swap dealers increases the potential for misuse of this information to the detriment of fund shareholders.

Second, because a fund may enter into on-exchange and OTC transactions with a number of different swap counterparties, a swap dealer may not have information regarding a fund's total

[10] In addition, limiting the participation of commodity index funds in the commodities markets could have a detrimental impact on other commodities markets participants, such as producers and other commercial participants.

[11] The Institute has made this point to the SEC on several occasions. *See* Letters from Paul Schott Stevens, President and Chief Executive Officer, Investment Company Institute, to Christopher Cox, Chairman, Securities and Exchange Commission, dated September 14, 2005, August 29, 2006, and September 19, 2008.

commodity exposure needed to determine whether the client has reached the designated limits. A swap client, such as a commodity index fund, would need to provide this sensitive and proprietary information to each swap dealer with which it enters into transactions. This could be time-consuming and costly.

Finally, requiring a swap dealer to determine a client's futures equivalent positions may be administratively burdensome because, unlike standardized futures contracts, commodity linked swaps are privately negotiated agreements with varying terms and conditions.

IV. Conclusion

The *bona fide* hedge exemption for swap dealers has allowed average investors, through commodity index funds and other funds that invest in commodities, to gain exposure to commodities as an asset class in order to diversify their portfolio and hedge against inflation without having a negative impact on the commodities markets. Implementing regulations that would eliminate or greatly limit the ability of average investors to participate in the commodities markets would be harmful to investors, funds, swap dealers, and the U.S. commodities markets as a whole. The Institute therefore recommends that the CFTC refrain from eliminating the *bona fide* hedge exemption for swap dealers. We believe that the activity of swap dealers stemming from the exemption is not a risk to market integrity and serves an important function in the commodities markets.

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We appreciate the opportunity to express our views on the Concept Release and look forward to working with the CFTC as it continues to examine these issues. In the meantime, if you have any questions, please feel free to contact me directly at (202) 371-5408 or Eva Mykolenko at (202) 326-5837.

Sincerely,

/s/ Ari Burstein

Ari Burstein
Senior Counsel

cc: The Hon. Gary Gensler, Chairman
The Hon. Michael V. Dunn, Commissioner
The Hon. Walter Lukken, Commissioner
The Hon. Jill E. Sommers, Commissioner
The Hon. Bart Chilton, Commissioner