



STATEMENT OF

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ON BEHALF OF THE

INVESTMENT COMPANY INSTITUTE

BEFORE THE

**SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES**

**COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES**

ON

“THE IMPACT OF DODD-FRANK ON CUSTOMERS, CREDIT, AND JOB CREATORS”

JULY 10, 2012

EXECUTIVE SUMMARY

- Operating under a remarkably comprehensive regulatory framework, mutual funds and other registered investment companies (“registered funds”) help over 90 million shareholders to achieve their financial goals. Congress did not direct the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) at these funds, because they were not a cause of the financial crisis. Nonetheless, the statute and rules implementing it will have important implications for all market participants, including registered funds and their advisers.
- Certain provisions of the Dodd-Frank Act are intended to promote bank safety and soundness and financial stability, but care must be taken to ensure that their implementation does not have unintended adverse consequences—for registered funds and their shareholders, the financial markets, or the broader economy.
 - **Volcker Rule.** The regulatory proposal to implement the Volcker Rule reaches much farther than Congress intended, inappropriately capturing some U.S. registered funds and virtually all non-U.S. retail funds. Any final rule should expressly exclude these funds from the definitions of “covered fund” and “banking entity.” The proposal also could impair the financial markets and limit investment opportunities for registered funds and their shareholders. ICI has provided recommendations for addressing these concerns in its comments to regulators.
 - **Designation of Systemically Important Nonbank Financial Companies (“SIFIs”).** It is important that the Financial Stability Oversight Council (“FSOC”) act deliberately in exercising its authority to designate nonbank SIFIs for heightened regulation and consolidated supervision by the Federal Reserve Board. SIFI designation is neither warranted nor appropriate for registered funds or their advisers because, among other things, they do not present the risks such designation is intended to address. While ICI welcomes the study of asset management companies the Office of Financial Research is undertaking on behalf of the FSOC, we feel strongly that: (1) it would be premature to evaluate such companies under the existing SIFI designation framework before completion of this analysis; and (2) the FSOC should publish the study (and any future material changes to its SIFI designation guidance) for public comment.
 - **Enhanced Prudential Standards for Nonbank SIFIs and Large Bank Holding Companies.** The Federal Reserve Board’s proposal to implement enhanced prudential standards under Section 165 of the Dodd-Frank Act is premature as applied to nonbank SIFIs, because the FSOC has not yet designated any such SIFIs. Without knowing which entities will be designated, the Federal Reserve Board cannot comply with its statutory obligations regarding nonbank SIFIs. The Federal Reserve Board therefore should exclude nonbank SIFIs and separately propose a process for prescribing the enhanced standards that will be applied to them.

- **Unlimited Insurance for Noninterest-Bearing Transaction Accounts.** In the Dodd-Frank Act, Congress granted circumscribed authority for the FDIC to provide unlimited deposit insurance only to specified accounts and only for a two-year period. Congress should reject calls to extend this program beyond its statutory expiration date, because the program has the potential to dislocate markets and increase systemic risk in times of market stress by creating an unlimited taxpayer-supported backstop for noninterest-bearing transaction accounts.
- In addition to the Volcker Rule, Dodd-Frank Act provisions on asset-backed securities (“ABS”) and derivatives have implications for registered funds as investors in the financial markets.
 - **Asset-Backed Securities.** As investors in ABS, registered funds have a strong interest in ABS markets that function fairly and in the interests of investors.
 - **Risk Retention.** ICI generally supports the goal of the joint regulatory proposal to implement the credit risk retention requirements imposed by the Dodd-Frank Act. We believe that the proposed standards for risk retention may not be appropriate or necessary for certain classes of ABS in which registered funds invest—in particular, notes issued by asset-backed commercial paper programs and securities issued by municipal tender option bond programs.
 - **Prohibition Against ABS Conflict of Interests.** ICI also supports the rule the Securities and Exchange Commission (“SEC”) has proposed to implement the prohibition under the Dodd-Frank Act against material conflicts of interest in connection with certain securitizations. The SEC should clarify, however, that the proposed rule excludes actions taken in connection with investing in an ABS by a registered fund that is an affiliate of an entity that structures or distributes an ABS. In addition, the proposed rule’s exception for liquidity commitments should not be viewed as inconsistent with the restrictions under the regulatory proposal to implement the Volcker Rule.
 - **Derivatives.** Registered funds are participants in the derivatives markets and use these instruments in a variety of ways. Accordingly, ICI and its members have encouraged reform efforts in the derivatives markets.
 - **Implementation of Title VII.** It is crucial for implementation of the new regulatory framework for derivatives to follow a sequential, deliberative and coordinated process to minimize unforeseen and unintended consequences for market participants, customers and the derivatives markets, including disruptions to the markets and risk mitigation strategies. Specifically, the implementation periods should: (1) afford adequate time for the SEC and the Commodity Futures Trading Commission (“CFTC”) to gather additional market data to inform future rulemaking; (2) allow market participants to build market infrastructures, modify

business operations, complete testing, and perform outreach and education of customers; and (3) phase in rule requirements by type of market participant and asset class.

- **The Status of Non-Deliverable Foreign Exchange Forwards.** Under the Dodd-Frank Act, foreign exchange (“FX”) swaps and forwards are considered swaps unless the Secretary of the Treasury makes a written determination that either or both should not be regulated as swaps. The Treasury has issued a proposed determination that would exempt FX swaps and forwards from the definition of swap, but would not include non-deliverable FX forwards (“NDFs”) within the exemption. ICI has consistently supported Treasury’s proposed exemption of FX swaps and forwards, and strongly believes that the exemption should extend to NDFs, which are functionally and economically identical to FX forwards. Treasury, in coordination with the CFTC or, if necessary, Congress, should clarify that FX forwards include both deliverable FX forwards and NDFs.
 - **The Process for Making a Swap “Available to Trade.”** Late last year, the CFTC, pursuant to the Dodd-Frank Act, proposed a process to establish which swaps will be subject to mandatory trading, or will be made “available to trade” on a designated contract market (“DCM”) or swap execution facility (“SEF”) for purposes of the Commodity Exchange Act. The CFTC’s proposed process would grant the DCMs and SEFs a significant role in making these determinations. To address the incentives a DCM or SEF may have to require that a swap be subject to mandatory trading, even in the absence of a liquid trading market for the swap, the CFTC should require DCMs and SEFs to consider objective standards or thresholds as part of the make “available to trade” determination process, and should make consideration of each standard/threshold mandatory.
 - **The Determination of Block Trades.** Pursuant to the Dodd-Frank Act, both the SEC and CFTC have issued proposals relating to block trades. Market transparency is a key element to ensuring the integrity and quality of the swaps markets, but that must be balanced against adequately protecting information regarding a registered fund’s block trades. It is critical that the SEC and CFTC adopt block thresholds that account for the liquidity in each unique category of swaps, calculate the thresholds regularly, and establish thresholds that are low enough to encourage the use of block trades.
- We wish to make the Subcommittee aware of an agency’s troubling use of the Dodd-Frank Act as a pretext for expanding its authority through unjustified regulation.
 - For almost thirty years, the CFTC has provided a uniform exclusion through its Rule 4.5 from regulations applicable to commodity pool operators for entities already subject to

another regulatory scheme. Invoking its supposed “more robust mandate” to “manage systemic risk” under Dodd-Frank, the CFTC has sharply curtailed this exclusion, but only for registered funds and not for other entities covered by the rule.

- In actuality, the CFTC’s amendments to Rule 4.5 were neither required nor even contemplated by the Dodd-Frank Act. The additional regulation that amended Rule 4.5 will impose on registered funds is redundant of the comprehensive regulation to which registered funds and their advisers are already subject by the SEC. The CFTC has not justified the need for these additional regulatory burdens, nor the significant costs they will impose on registered funds and their shareholders. Nor has the agency adequately explained how registered fund shareholders, which already enjoy comprehensive protections under the federal securities laws, will benefit from this additional, redundant layer of regulation.

I. INTRODUCTION

My name is Thomas Lemke. I am General Counsel and Executive Vice President of Legg Mason & Co., LLC. We are a Baltimore-based global asset management firm that manages more than \$630 billion in mutual funds and other assets for our clients.

I am pleased to appear before the Subcommittee today on behalf of the Investment Company Institute (“ICI”) to discuss the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) on customers, credit, and job creators. ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (“ETFs”), and unit investment trusts (“UITs”).¹ ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of registered funds, their shareholders, directors, and advisers. As of July 2012, members of ICI manage total assets of \$12.9 trillion.

Over 90 million shareholders depend on registered funds in seeking to achieve their most important financial goals, such as saving for college, purchasing a home, or providing for a secure retirement. Registered funds and their advisers operate under a remarkably comprehensive framework of regulation, including the Investment Company Act of 1940 (“Investment Company Act”). That framework has been enhanced over the years by Congress and the Securities and Exchange Commission (“SEC”), the primary mutual fund regulator. Its major features—strict limits on leverage, daily mark-to-market valuation, exceptional transparency, and strong governance, among others—again proved their worth to investors through the financial turmoil of recent years.

Enacted in response to that turmoil, the Dodd-Frank Act is very broad and complex and touches nearly every part of the financial services industry. It is not directed at registered funds, because they were not a cause of the financial crisis. Nonetheless, in a number of areas the statute and rules implementing it will have important implications for all participants in the financial markets, including registered funds and their advisers.

As we approach the second anniversary of the Dodd-Frank Act, regulators have made significant progress with implementation efforts. But there is still much to do and important questions remain unanswered. During the implementation process, ICI and its members have been closely following regulatory developments and providing extensive comments. The registered fund industry has a unique perspective on our regulatory system, because our funds are both issuers of securities and investors in domestic and international financial markets. Our efforts are focused on, among other things, ensuring that the regulations implementing the Dodd-Frank Act do not have harmful or unintended consequences for registered funds and their shareholders—or for the financial markets or the broader economy—and that any regulations strike the right balance between costs and benefits.

¹ For ease of reference, this testimony refers to all types of U.S. registered investment companies—including mutual funds, closed-end funds, ETFs, and UITs—as “registered funds,” unless the context requires otherwise.

Below, we highlight areas of continuing focus for ICI and its members. First, we discuss certain provisions of the Dodd-Frank Act intended to promote bank safety and soundness and financial stability, but whose implementation may have adverse consequences for registered funds, their advisers, and fund investors ([Section II](#)). Second, we discuss implementation of the Dodd-Frank Act provisions on asset-backed securities and derivatives, which will affect registered funds as investors in the markets ([Section III](#)). Finally, we discuss a clear example of regulatory overreach in which the Dodd-Frank Act is used as a pretext for the agency’s rulemaking ([Section IV](#)).

II. UNINTENDED EFFECTS FROM RULES DESIGNED TO PROMOTE FINANCIAL STABILITY

The Dodd-Frank Act contains various provisions aimed at enhancing the safety and soundness of banks and identifying and mitigating potential risks to financial stability. ICI concurs with these broad goals, as a more resilient financial system will benefit all market participants. But building this more resilient system is challenging and complex, and care must be taken to avoid unintended negative consequences. That is why ICI, like other market participants, believes that *how* these Dodd-Frank provisions are implemented is of utmost significance.

Below, we discuss our specific concerns regarding regulatory efforts to implement the “Volcker Rule,” and to designate and regulate systemically important nonbank financial institutions. We also explain our strongly held view that Congress should not extend further Dodd-Frank’s grant of temporary unlimited deposit insurance for noninterest-bearing transaction accounts.

A. Concerns with the Proposal to Implement the Volcker Rule

1. U.S. Registered Funds

Congress enacted the “Volcker Rule” provision of the Dodd-Frank Act (Section 619) in order to restrict banks from using their own resources to trade for purposes unrelated to serving clients and to address perceived conflicts of interest in certain bank transactions. The Volcker Rule was not directed at registered funds. Unfortunately, the proposal to implement the Volcker Rule (“Proposed Rule”)² nonetheless raises a number of concerns for the U.S. registered fund industry.

If adopted in its original form, the Proposed Rule would reach much farther than it seems Congress intended. For example, the Proposed Rule could treat many registered funds as hedge

² See Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (November 7, 2011), issued by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System (“Federal Reserve”), Federal Deposit Insurance Corporation (“FDIC”), and SEC. The Commodity Futures Trading Commission (“CFTC”) was not a party to the Proposed Rule; instead, it issued a separate yet substantively similar proposal to implement the Volcker Rule. See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (February 14, 2012). Below, we refer to the foregoing regulators collectively as the “Agencies.”

funds—a result that contradicts the plain language that Congress passed. The Proposed Rule also could restrict banks from playing their historic role as market makers buying and selling securities—despite the fact that Congress specifically designated “market making-related activity” as a “permitted activity” for banks under the Volcker Rule. If banks cannot provide these services, particularly in the less liquid fixed income and derivatives markets and the less liquid portions of the equity markets, registered funds and other investors likely would face wider bid-ask spreads, higher transaction costs, and diminished returns. The Proposed Rule also could greatly impair the U.S. financial markets by imposing stringent restrictions that go well beyond what is necessary to effectuate Congress’ intent in enacting the Volcker Rule, potentially hurting our broader economy and impacting job creation and investments in U.S. businesses overall. Finally, the Proposed Rule, as issued, could limit investment opportunities for registered funds and their shareholders.

ICI’s comment letter on the Proposed Rule described these concerns in detail.³ Below, we highlight our main concerns and provide recommendations for addressing them. Given the significant changes we believe are necessary to address our concerns and those of other commenters, ICI recommended in its comment letter, and still strongly urges, that the Agencies issue a revised proposal for comment before adopting any final rule.

- a. *Organization, Sponsorship and Normal Activities of Registered Funds*
 - *The Rule Expressly Should Exclude All Registered Funds from the Definition of “Covered Fund”*. Under the Dodd-Frank Act, a banking entity is prohibited from having an ownership interest in, or acting as sponsor to, a hedge fund, private equity fund, or “similar fund” as the Agencies determine by rule—collectively defined in the Proposed Rule as “covered funds.” However, the Proposed Rule would include within “covered fund” any investment vehicle that is considered a “commodity pool” under Section 1a(10) of the Commodity Exchange Act, thereby greatly expanding the reach of the Volcker Rule, even to the extent of sweeping in a number of registered funds. ICI believes that treating *any* registered fund as “similar” to a hedge fund or private equity fund for purposes of the Volcker Rule is contrary to Congressional intent and, frankly, common sense. Providing an express exclusion for registered funds from the definition of “covered fund” would avoid this unintended result.
 - *The Rule Expressly Should Exclude All Registered Funds from the Definition of “Banking Entity”*. The Proposed Rule suggests that a registered fund generally would not be considered a subsidiary or affiliate of the banking entity that sponsors or advises it.

³ See Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Ms. Elizabeth M. Murphy, Secretary, SEC, *et al.*, dated February 13, 2012 (“ICI Volcker Comment Letter”), available at <http://www.ici.org/pdf/25909.pdf>. See also Statement of the Investment Company Institute for Hearing on “Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation,” Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives (January 18, 2012), available at <http://financialservices.house.gov/UploadedFiles/HHRG-112-BA-WState-ICI-20120118.pdf>.

Without an express exclusion in the rule text, however, it is possible that some registered funds could nevertheless inadvertently become subject to all of the prohibitions and restrictions in the Volcker Rule—a result not intended by Congress. For example, during the period following the launch of a new registered fund by a bank-affiliated sponsor, when all or nearly all of the fund’s shares are owned by that sponsor (the “seeding process” for a new fund), the registered fund could be considered an affiliate of the banking entity and, thus, subject to the Volcker Rule in its own right. Providing an express exclusion for registered funds from the definition of “banking entity” would avoid this unintended result without thwarting in any way the policy goals of the Volcker Rule.

- *The Rule Should Not Limit the Ability of Banking Entities to Serve as Authorized Participants for Registered Exchange-Traded Funds and Conduct Related Activities.* The proprietary trading provisions of the Proposed Rule call into question whether banking entities could continue to serve as Authorized Participants (“APs”) for ETFs registered under the Investment Company Act and conduct related activities. ETFs are similar to mutual funds (the most common type of registered fund) except that they list their shares on a securities exchange, thereby allowing retail and institutional investors to buy and sell shares throughout the trading day at market prices. Increasingly popular with investors, ETFs use a different process for offering their shares. APs alone transact in shares directly with ETFs, in large amounts (typically involving 50,000 to 100,000 ETF shares) based not on market prices but on the ETF’s daily net asset value. AP transactions with an ETF are a unique and controlled form of arbitrage trading that, in the view of the SEC, is a critical component of maintaining efficient pricing in the ETF marketplace and protecting ETF investors. Some APs also may engage in traditional market making activities in the ETFs with which they participate. The Agencies should revise the Proposed Rule to ensure that APs can continue to fulfill these important roles.
- b. *Impact on the Financial Markets*
- *Liquid and Efficient Markets are Important for Registered Funds.* Banking entities are key participants in providing liquidity in the financial markets, promoting the orderly functioning of the markets as well as the commitment of capital when needed by investors to facilitate trading. The Proposed Rule has the potential to decrease market liquidity, particularly for the fixed-income and derivatives markets, and the less liquid portions of the equities markets. A reduction of liquidity would have serious implications for registered funds, leading to wider bid-ask spreads, increased market fragmentation, and ultimately the potential for higher costs for fund shareholders.
 - *The Complexity of, and Difficulties of Complying with, the Proposed Rule Threaten Market Liquidity and May Adversely Impact Registered Funds.* Much of the concern surrounding the effect of the Proposed Rule on market liquidity arises from the complexity of the Proposed Rule and its exemptions from the proprietary trading prohibition. ICI supports

suggestions to recast what appear to be rigid criteria defining permitted activities under the Proposed Rule as guidance that could be incorporated into banking entities' policies and procedures.

- *The Presumption of Prohibited Activity is Unwarranted.* The Proposed Rule generally presumes that a banking entity's short-term principal trading activity is prohibited proprietary trading. This presumption of prohibited activity prejudices the analysis of a banking entity's trading activity from the outset. Moreover, the process to rebut the Proposed Rule's presumption would be extremely complex and onerous.
- *The Conditions of the Proposed Exemptions Do Not Reflect the Operation of the Financial Markets.* The Proposed Rule appears tailored primarily for the traditional trading of equities on an agency-based "last sale" model, which differs substantially from how fixed income and other markets operate. It does not reflect that, in the majority of the financial markets, market makers provide liquidity by acting as principal. It does not take into account the need to provide flexibility and discretion to market makers to enter into transactions to build inventory.
- *The Conditions of the Proposed Exemption for Market Making-Related Activities are Impractical.* The conditions under the market making-related activities exemption are extremely complex and we believe will be so difficult to comply with as to be effectively unworkable in a number of financial markets and for a significant number of financial instruments.
- *The Risk-Mitigating Hedging Exemption Must be Flexible.* The conditions provided under the proposed risk-mitigating hedging exemption create uncertainty as to whether a specific hedge would fulfill the requirements of the exemption. The exemption should be made flexible enough to allow banking entities appropriately to manage all possible risks and to facilitate hedging against overall portfolio risk; it should not be a transaction-by-transaction analysis.
- *The Proposed Government Obligations Exemption Should be Expanded to Cover All Municipal Securities and Foreign Sovereign Obligations.* The proposed exemption for trading in certain government obligations does not extend to transactions in obligations of an *agency or instrumentality* of any State or political subdivision. ICI recommends that the exemption be expanded to include *all* municipal securities, which would be consistent with the current definition of municipal securities under the Securities Exchange Act of 1934 ("Exchange Act"). The Proposed Rule also should be expanded to provide an exemption for foreign sovereign obligations; such an exemption is consistent with Congressional intent to limit the

extraterritorial reach of the Volcker Rule and with the purposes of the Volcker Rule.

- *The Agencies' Proposed Implementation of the Proprietary Trading Prohibition Would Impact the Structure of the Financial Markets and the U.S. Economy Overall.* The Agencies' proposed implementation of the proprietary trading prohibition could have negative implications for capital formation. Banking entities also may find it difficult to remain in the market making business, which could lead to less regulated and less transparent financial institutions performing these activities. The over-broad restrictions of the Proposed Rule, which go well beyond what is necessary to effectuate Congress' intent in enacting the Volcker Rule, could hurt our broader economy, impacting job creation and investments in U.S. businesses overall.
- c. *Limiting Investment Opportunities for Registered Funds and Their Shareholders*
 - *The Foreign Trading Exemption Should Be Revised to Avoid Adverse Effects on U.S. Registered Funds' Investments in Certain Foreign Securities.* Although Congress intended that trading outside of the United States be a “permitted activity” under the Volcker Rule, the Proposed Rule narrowly defines which transactions would be considered to take place outside of the United States—and, in so doing, departs from an existing and well-understood U.S. securities regulation (Regulation S under the Securities Act of 1933) that governs whether an offering takes place outside of the United States. Many registered funds invest in securities, such as sovereign debt securities denominated in foreign currency, for which the primary and most liquid market is outside of the United States. These transactions often involve non-U.S. banking entities as counterparties. The narrow exemption in the Proposed Rule for trading outside of the United States may well cause some non-U.S. banking entities to avoid engaging in transactions with persons acting on behalf of U.S. registered funds, even when those transactions would comport fully with Regulation S. As a result, U.S. registered funds' access to non-U.S. counterparties could decrease significantly, and liquidity in some markets could be reduced. Revising the Proposed Rule to conform to the existing approach under Regulation S would avoid these highly undesirable results.
 - *The Rule Should Exempt Asset-Backed Commercial Paper and Municipal Tender Option Bond Programs.* The Proposed Rule would impair two particular types of securitization activities that are part of traditional banking activities—notes issued by asset-backed commercial paper (“ABCP”) programs and securities issued pursuant to municipal tender option bond (“TOB”) programs.⁴ This would have significant negative implications for issuers of these financing vehicles and their investors, many of which are registered funds. There is no indication, however, that Congress intended to include ABCP or municipal

⁴ ABCP programs and municipal TOB programs are discussed further in Section III.A, *infra*.

TOB programs within the scope of the Volcker Rule; rather, Congress specifically sought to avoid interfering with longstanding, traditional banking activities. The provision of credit to companies to finance receivables through ABCP, as well as to issuers of municipal securities to finance their activities through TOBs, are both areas of traditional banking activity that should be distinguished from the types of financial activities that Congress sought to restrict under the Volcker Rule. Without liquid ABCP and TOB markets, credit funding for corporations and municipalities would be unduly and unnecessarily constrained. It is therefore important that the Proposed Rule be revised to exempt ABCP and municipal TOB programs.

2. Non-U.S. Retail Funds

The Proposed Rule raises similar and additional concerns for funds that are publicly offered and substantively regulated outside of the United States (“non-U.S. retail funds”).⁵ Without substantial changes, the Proposed Rule would unduly impede the ability of both U.S. and non-U.S. entities to organize and sponsor, and operate non-U.S. retail funds and harm certain financial markets, market participants, and financial instruments.

a. *Organization, Sponsorship and Normal Activities of Non-U.S. Retail Funds*

- *The Rule Expressly Should Exclude All Non-U.S. Retail Funds from the Definitions of “Covered Fund” and “Banking Entity”.* It seems clear that Congress did not intend for the Volcker Rule to target non-U.S. counterparts to U.S. registered funds. Yet, under the Proposed Rule as drafted, non-U.S. retail funds are inappropriately encompassed by the definitions of “covered fund” and, in some circumstances, “banking entity,” and could face serious and dramatically disruptive effects on their organization and operation. In fact, if the Proposed Rule is not revised, the Volcker Rule will be applied more restrictively outside of the United States than within it—an odd result in itself, and surely not one Congress intended. Overall, many of the difficulties and problems posed for non-U.S. retail funds could be addressed by excluding non-U.S. retail funds from the definitions of “covered fund” and “banking entity.” Such an approach would not compromise Congress’ intent with respect to hedge funds and private equity funds and is in keeping with Congress’ intent to limit the extraterritorial impact of the Volcker Rule.⁶

⁵ See Letter from Dan Waters, Managing Director, ICI Global (“ICIG”), to Ms. Elizabeth M. Murphy, Secretary, SEC, *et al.*, dated February 13, 2012. ICIG, our global affiliate, is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICIG seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICIG manage total assets in excess of US \$1 trillion.

⁶ In its comment letter, ICIG recommended several other changes to limit the disruption caused by the Proposed Rule should the Agencies choose not to exclude non-U.S. retail funds from “covered fund” and “banking entity.”

b. *Impact on the Financial Markets*

- *The Proposed Rule Should Utilize Regulation S to Delineate Offshore Securities Transactions.* Without revision, the Proposed Rule will result in less liquidity and smaller and/or more fragmented markets for many securities. Certain transactions may be incredibly complex and difficult to accomplish in a sensible and cost-efficient manner. Because the foreign trading exemption is focused on offshore securities transactions, we believe that the Proposed Rule should be revised to follow the approach of Regulation S, which has been the global standard for defining the line between the U.S. and non-U.S. securities markets for more than 20 years.
- *The Rule Should Not Limit the Ability of Banking Entities to Serve as Authorized Participants for Non-U.S. Retail Exchange-Traded Funds and Conduct Related Activities.* The Proposed Rule should be amended to assure that the ability of banking entities to serve as APs for non-U.S. retail funds is not prohibited or constrained. This could be achieved by explicitly designating non-U.S. retail ETF trading activity by banking entity APs as a permitted “market making” activity and excluding non-U.S. retail ETFs from the definition of a covered fund. In addition, if non-U.S. retail funds are not excluded from the definition of “covered fund,” the Proposed Rule would need to be revised to accommodate the purchase of non-U.S. retail ETFs by APs that are banking entities. Many of the most active APs in the non-U.S. ETF market are banking entities.
- *Liquid and Efficient Markets Are Important for Non-U.S. Retail Funds.* Similar to the concerns expressed above, non-U.S. retail funds are apprehensive about the effects the Proposed Rule will have on the liquidity of the markets, both in the United States, where many of these funds trade, and abroad (particularly with respect to obligations of foreign governments and international and multinational development banks). We believe that failure to amend the Proposed Rule to address these concerns would severely harm funds and their investors.

B. Designation of Systemically Important Nonbank Financial Companies

In testimony for the Subcommittee’s June 2011 hearing on oversight of the mutual fund industry, ICI discussed its views on systemic risk regulation.⁷ We emphasized why it is important that the Financial Stability Oversight Council (“FSOC”) act deliberatively in exercising its authority under the Dodd-Frank Act to designate systemically important nonbank financial companies (“SIFIs”) for

⁷ See Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, on “Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence” (June 24, 2011) (“ICI June 2011 Testimony”), available at <http://financialservices.house.gov/UploadedFiles/062411stevens.pdf>, at 40.

heightened prudential regulation and consolidated supervision by the Federal Reserve. We also expressed our strongly held view that SIFI designation is neither warranted nor appropriate for registered funds or their advisers because, among other things, they do not present the risks that such designation is intended to address.

We conveyed these same views to the FSOC as it worked to develop a rule to govern the SIFI designation process.⁸ When it adopted a final rule and associated guidance earlier this year, the FSOC indicated that it and the Office of Financial Research (“OFR”) are continuing to analyze what threats to financial stability—if any—arise from asset management companies and whether such threats can be mitigated by SIFI regulation or are better addressed through other regulatory measures.⁹ ICI welcomes this further analysis. It suggests the FSOC recognizes that the risk profile of asset management companies differs from that of banks and of other nonbank financial companies and, moreover, that it is committed to exercising its SIFI designation authority in a careful and thoughtful manner to achieve its intended goals. ICI believes this review will lead the FSOC to conclude, at the very least, that SIFI designation would not be an appropriate regulatory tool for addressing risks, if any, that registered funds or their advisers might raise regarding financial stability.

ICI feels strongly that it would be premature for the FSOC to evaluate asset management companies under its existing SIFI designation framework before its further analysis has been completed. We also believe that, to further inform its views, the FSOC should publish for comment the study the OFR is undertaking. Openness and transparency are critical throughout this process, especially for new governmental bodies such as the OFR. Finally, if the FSOC determines to issue additional guidance regarding asset management companies (or to make other material changes to the guidance already issued), it should provide the public with notice and the opportunity to comment before finalizing any such guidance.¹⁰ We support similar recommendations recently made by a bipartisan group of members of Congress, including Representatives John Carney and Nan Hayworth, in a letter to Treasury Secretary (and FSOC Chairman) Timothy Geithner.¹¹ All of these recommended procedural

⁸ See Letters from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated Nov. 5, 2010, Feb. 25, 2011, and December 20, 2011, available at <http://www.ici.org/pdf/24696.pdf>, <http://www.ici.org/pdf/24994.pdf>, and <http://www.ici.org/pdf/25729.pdf>, respectively.

⁹ FSOC, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21637 (April 11, 2012) (“SIFI Designation Adopting Release”), at 21644.

¹⁰ See Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated December 20, 2011, *supra* n. 8. The FSOC has only indicated that it *may* provide an opportunity for public comment, as it deems appropriate. SIFI Designation Adopting Release, *supra* note 9, 77 Fed. Reg. at 21647.

¹¹ See Letter from Members of Congress John Carney, Nan Hayworth, Gary Peters, Gary Miller, Gwen Moore, John Campbell, Michael Capuano, David Schweikert, Brad Sherman, Donald Manzullo, and Gregory Meeks, to The Honorable Timothy Geithner, Chairman, FSOC, dated June 15, 2012.

steps are consistent with and would help demonstrate the FSOC’s stated “commit[ment] to fostering transparency with respect to the Designation Process.”¹²

C. Enhanced Prudential Standards for Nonbank SIFIs and Large Bank Holding Companies

To date, FSOC has designated no nonbank organization as a SIFI. In January of this year, however, the Federal Reserve issued a proposal under Sections 165 and 166 of the Dodd-Frank Act outlining the enhanced prudential standards that would apply both to any entity so designated and to bank holding companies with at least \$50 billion in total consolidated assets (“large BHCs”).¹³ ICI’s comment letter on the proposal discussed the following two areas of concern with the Federal Reserve’s approach.¹⁴

1. The Section 165/166 Proposal Ignores Statutory Obligations

First, it is premature for the Federal Reserve to apply this proposal to nonbank SIFIs. Without knowing which entities will be subject to enhanced prudential standards, the Federal Reserve cannot comply with its statutory obligation to take into account differences among nonbank SIFIs and large BHCs based on specified considerations.¹⁵ It is therefore not surprising that the overall approach of the proposal is to apply the “same set” of enhanced prudential standards to all nonbank SIFIs and large BHCs. This approach is inconsistent, however, with what the statute requires. Moreover, applying a bank-oriented regulatory framework to *all* covered companies, as the proposal does, disregards Congressional recognition that for purposes of prescribing enhanced prudential standards under Section 165, one size *does not* fit all.¹⁶

The danger in this approach is illustrated by the proposed risk-based capital and leverage requirements. Section 165(b)(1)(A)(i) provides that the Federal Reserve, in consultation with the FSOC, may determine that risk-based capital requirements and leverage limits are inappropriate for a particular company because of the company’s activities or structure. In such a case, Congress has

¹² FSOC, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 76 Fed. Reg. 64264, 64267 (October 18, 2011.)

¹³ Board of Governors of the Federal Reserve System, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg. 594 (Jan. 5, 2012) (“Section 165/166 Proposal”).

¹⁴ See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, dated April 30, 2012, available at <http://www.ici.org/pdf/26118.pdf>.

¹⁵ The considerations are: (1) the factors described in subsections (a) and (b) of Section 113 of the Dodd-Frank Act; (2) whether the company owns an insured depository institution; (3) nonfinancial activities and affiliations of the company; and (4) any other risk-related factors that the Federal Reserve determines appropriate.

¹⁶ See, e.g., Section 165(b)(3) of the Dodd-Frank Act (requiring, among other things, that the Federal Reserve adapt the prudential standards in light of a company’s predominant line of business, including assets under management or other activities for which particular standards may not be appropriate).

directed that the Federal Reserve *must* apply “other standards that result in similarly stringent risk controls.” But the proposal makes no mention of the possibility that for some companies, risk-based capital requirements and leverage limits may not apply in the same way or even at all. To the contrary, the proposal would apply the specified requirements to any nonbank covered company “as if it were a bank holding company.”¹⁷

It goes without saying that applying enhanced prudential standards that are inappropriate or unworkable will not further the policy goals underlying Section 165. Capital requirements are a good example because, while they are a tool of proven value for banks and broker-dealers, they simply do not make sense in all contexts, including in the case of registered funds and their advisers.¹⁸

For these reasons, ICI recommends that the Federal Reserve exclude nonbank SIFIs from its rulemaking at this time. Instead, the Federal Reserve should propose, in a separate rulemaking, a process for prescribing the enhanced standards that will be applied to nonbank SIFIs, taking into account the characteristics and risks of those entities so designated.

2. Proposed Single Counterparty Credit Limits Should Not Treat Registered Funds as “Subsidiaries” of Covered Company Sponsors/Advisers

Second, ICI is concerned about the possible application of the single counterparty credit limits proposed by the Federal Reserve. Section 165(e) of the Dodd-Frank Act directs the Federal Reserve to establish single-counterparty credit limits for large BHCs and nonbank SIFIs (referred to collectively in the proposal as “covered companies”) to limit the risks that the failure of any individual firm could pose to a covered company. Under the proposal, the aggregate net credit exposure of a covered company and all of its “subsidiaries” to any unaffiliated counterparty and its subsidiaries may not exceed 25 percent of the covered company’s capital stock and surplus (reduced to 10 percent if a covered company and its counterparty are both either a bank holding company with \$500 billion or more of total consolidated assets or a nonbank SIFI of any size).

The term “subsidiary,” as defined in the proposal, generally would not include a registered fund that is sponsored or advised by a covered company, and thus the credit exposure of a registered fund to a counterparty would not be aggregated with the credit exposure of the fund’s sponsor or adviser to the same counterparty. ICI believes this is the appropriate outcome because it is well settled under Federal and State law that registered funds are independent legal entities from their sponsors/advisers.

In its release discussing the proposal, however, the Federal Reserve asked whether this outcome may be at odds with the support that some money market funds received from their sponsors during the financial crisis. The Federal Reserve requested comment on whether a money market fund or other

¹⁷ See proposed § 252.13(b)(1) and (b)(3).

¹⁸ See, e.g., Letter from Scott C. Goebel, Senior Vice President and General Counsel, FMR Co., to Financial Stability Oversight Council, dated Dec. 19, 2011.

registered fund or investment vehicle should be included as part of its sponsoring covered company for purposes of this rule.¹⁹

ICI strongly disagrees with any suggestion that the proposed single counterparty credit limits be applied to a registered fund sponsored or advised by a covered company. As our comment letter to the Federal Reserve explained, treating registered funds in this manner would not further the purpose of the proposed credit limits, and would unnecessarily disrupt the operations of the registered funds while creating potential conflicts of interest between those funds and their covered company sponsor/adviser. Moreover, such treatment could create the inaccurate perception that support from a registered fund's adviser or sponsor is likely—a result directly contrary to the Federal Reserve's objective.

D. Unlimited Insurance for Noninterest-Bearing Transaction Accounts

Section 343 of the Dodd-Frank Act requires the FDIC to provide unlimited insurance for “noninterest-bearing transaction accounts” for two years starting December 31, 2010.²⁰ This provision is intended to give depositors of insured depository institutions, most notably corporations and other institutional investors, additional assurance that their balances in noninterest-bearing transaction accounts will be safe as the financial crisis wanes.²¹ As with any program that insures customer funds, however, the insurance coverage authorized by Section 343 poses potential costs to taxpayers and raises the risk of dislocations elsewhere in the financial system. Presumably in recognition of these potential costs and risks, Congress granted circumscribed authority, requiring the FDIC to provide unlimited insurance for only specified accounts, and for only a two-year period.

We understand that some are calling for Congress to extend this unlimited insurance program beyond its statutory expiration date.²² ICI strongly opposes any such extension. We view the program as having the potential to dislocate markets and increase systemic risk in times of market stress by creating an unlimited taxpayer-supported backstop for these transaction accounts.²³

¹⁹ See Section 165/166 Proposal, *supra* note 13, 77 Fed. Reg. at 614-15 (Question 24).

²⁰ Section 343 provides for the “prospective repeal” of the unlimited insurance requirement effective January 1, 2013.

²¹ Section 343 is similar to, but also differs in certain key respects from, the Transaction Account Guarantee Program (“TAGP”) the FDIC first adopted in October 2008. Originally set to expire on December 31, 2009, the TAGP was extended through June 30, 2010 and subsequently through December 31, 2010. See FDIC, *Deposit Insurance Regulations; Unlimited Coverage for Noninterest-bearing Transaction Accounts*, 75 Fed. Reg. 60341 (Sept. 30, 2010), at 60342.

²² See, e.g., Joe Adler, *Banker's Banks Add to Calls for Extending TAG*, American Banker, June 26, 2012, available at http://www.americanbanker.com/issues/177_123/bankers-banks-transaction-account-guarantee-extension-1050448-1.html.

²³ See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation (October 10, 2010), available at <http://www.fdic.gov/regulations/laws/federal/2010/10c48AD37p.PDF> (commenting on FDIC proposal to implement Section 343).

To understand ICI's concerns, it is helpful first to understand the economic role of deposit insurance and how deposit insurance can influence the actions of banks and depositors, as well as investors in the broader markets. Banks have limited ability to liquidate assets quickly to meet large, unexpected withdrawals. Deposit insurance reduces the probability of bank runs by eliminating the potential advantage enjoyed by those depositors who are first to withdraw their money from a bank. Greater stability of bank deposits provides greater stability in the credit creation process and the overall economy.

Despite its demonstrated benefits, however, deposit insurance also entails risks for the financial system. For example, insurance reduces the incentives for insured depositors to monitor the creditworthiness of banks, which in turn creates a moral hazard that can encourage banks to take additional risks, knowing that depositors will not withdraw their deposits if the bank's financial condition deteriorates.²⁴ In addition, deposit insurance can cause other systemic risks for financial markets by increasing the propensity for investors to sell off assets—such as stocks, bonds, mutual fund shares, and other securities—and move the proceeds into insured deposits. As the FDIC has previously observed, this behavior can produce or exacerbate broader market dislocations during periods of financial stress.²⁵

Indeed, recent experience suggests that such activity would worsen any future financial crisis and reduce credit available to businesses, state and local governments, and other borrowers. Depository institutions would be unlikely, and in many cases unable, to buy the assets investors were selling. Instead of risking a recurrence, every effort should be made to avoid such a series of events.

Historically, the risks posed by deposit insurance programs have been mitigated by capping the amount of a depositor's account that is insured (currently \$250,000).²⁶ In the case of the insurance

²⁴ See, e.g., FDIC, *The Deposit Insurance Funds: Options Paper* (Aug. 2000), available at <http://www.fdic.gov/deposit/insurance/initiative/optionpaper.html> (“2000 Options Paper”) (recognizing that “deposit insurance can create moral hazard and increase the risk and cost of failure if deposit insurance premiums do not fully compensate the FDIC for increases in risk posed by particular banks and thrifts. By assuming the risk of loss that would otherwise be borne by depositors, deposit insurance eliminates any incentive for depositors who are fully insured to monitor bank or thrift risk, thus reducing what is known as ‘depositor discipline.’ Management can therefore take greater risks without increasing the depository institution's cost of funds.”).

²⁵ See *id.* (“There is also the possibility of a large shift of household assets into insured deposit accounts in the event of financial market volatility. There is currently more than \$11 trillion outstanding in U.S. equity holdings (including mutual fund shares) alone. In a protracted bear market, some of these funds could be transferred to insured deposits.”). See also Alan S. Blinder and R. Glenn Hubbard, *Blanket Deposit Insurance is a Bad Idea*, *WSJ Asia*, Oct. 16, 2008 (arguing that 100% federal deposit insurance would pull funds out of other assets, including money market funds and other money market instruments, as well as out of other countries, as occurred when deposits flowed from Britain to Ireland after Ireland instituted a deposit guarantee).

²⁶ See 2000 Options Paper, *supra* note 24 (“The coverage limit represents a balance between the goals of deposit insurance, on the one hand, and the need to limit moral hazard and the risk to taxpayers and the insurance funds, on the other.”).

authorized by Section 343 of the Dodd-Frank Act, the statutory limits on the types of accounts covered and the December 31, 2012 termination date should serve to reduce the possible negative effects of the program. With the stability of the U.S. financial system at stake, the importance of these limits cannot be overemphasized.²⁷ Congress therefore should resist any efforts to vitiate them.

III. OTHER ISSUES AFFECTING REGISTERED FUNDS AS INVESTORS IN THE MARKETS

As discussed above, the regulatory proposal to implement the Volcker Rule raises significant concerns for registered funds and their shareholders, including concerns for funds as investors in the financial markets. As institutional investors that invest nearly \$13 trillion on behalf of over 90 million shareholders, registered funds have a strong interest in regulations that affect the functioning of the financial markets. ICI regularly provides input on behalf of its members on a variety of matters relevant to registered funds' participation in the financial markets.²⁸ The discussion below focuses on certain implications of the Dodd-Frank Act for registered funds' investments in the asset-backed securities ("ABS") market and the derivatives markets.

A. Asset-Backed Securities

The Dodd-Frank Act includes numerous provisions relating to ABS disclosure, reporting, risk retention, and conflicts of interest that were intended to address issues that arose during the financial crisis.²⁹ As investors in ABS, registered funds have a strong interest in ABS markets that function fairly and in the interests of investors.³⁰

²⁷ ICI pointed to similar concerns and risks associated with any potential unlimited federal guarantee of assets invested in money market mutual funds, notably the risk of exacerbating the financial crisis by drawing large sums of deposits away from banks. See Investment Company Institute, *Report of the Money Market Working Group*, March 17, 2009 ("MMWG Report"), at 64-65. As noted in the MMWG Report, these risks are not theoretical. As a result, during the development in September 2008 of the Treasury Department's Money Market Fund Guarantee Program, ICI was a strong proponent of limiting the coverage and duration of that program.

²⁸ See, e.g., Appendix to Testimony of Kevin Cronin, Global Head of Equity Trading, Invesco, on Behalf of the Investment Company Institute, before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, on "Market Structure: Ensuring Orderly, Efficient, Innovative and Competitive Markets for Issuers and Investors" (June 20, 2012) (listing key ICI comments and statements on market structure issues), available at <http://financialservices.house.gov/UploadedFiles/HHRG-112-BA16-WState-KCronin-20120620.pdf>.

²⁹ See, e.g., Subtitle D of the Dodd-Frank Act, "Improvements to the Asset-Backed Securitization Process" (Sections 941-946).

³⁰ Registered funds also have an interest in strong disclosure and reporting standards for ABS, and we have, in the past, supported the SEC's efforts to improve disclosure and reporting for ABS. See, e.g., Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC, dated October 4, 2011, available at <http://www.ici.org/pdf/25532.pdf>; Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC, dated November 15, 2010, available at <http://www.ici.org/pdf/24712.pdf>; Letter from Karrie McMillan,

1. Risk Retention

In March 2011, six federal regulators (the “Regulators”) jointly issued a proposal to implement the credit risk retention requirements imposed by the Dodd-Frank Act.³¹ The proposal generally requires an ABS sponsor to retain not less than five percent of the credit risk of any asset that the sponsor, through the issuance of the ABS, transfers, sells, or conveys to a third party. ICI supports the goal of the proposal, as registered funds have a strong interest in ensuring that securitizers of ABS act consistently with the interests of investors. We are concerned, however, that the proposed standards for risk retention may not be appropriate or necessary for certain classes of ABS in which registered funds invest.³² Specifically, we do not believe that the proposed requirements sufficiently reflect differences among certain classes of ABS or market practice for those particular securities.³³ This is particularly so with respect to notes issued by ABCP programs and securities issued by municipal TOB programs.

The proposal includes a risk retention option specifically designed for ABCP programs that meet certain conditions. ABCP programs are short-term, senior-secured investment vehicles that issue instruments in the money markets. They are used by a wide variety of corporations—such as banks, finance companies, and broker-dealers—to obtain low-cost financing for a diverse range of financial receivables. ABCP programs are referred to as “asset-backed” because the entities that issue the ABCP own, or have security interests in, multiple pools of various types of financial assets. Most existing ABCP programs could not meet the proposed rule’s conditions, however. ICI recommends, in lieu of the ABCP risk retention option, that the Regulators exclude or exempt from the proposal’s risk retention requirements those bank-sponsored ABCP programs that meet strict criteria ICI suggested in its comment letter to the Regulators.³⁴ These criteria reflect an alignment of interests between the ABS

General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC, dated August 2, 2010, available at <http://www.ici.org/pdf/24465.pdf>.

³¹ *Credit Risk Retention*, 76 Fed. Reg. 24090 (April 29, 2011). Section 941 of the Dodd-Frank Act, which mandates risk retention requirements, added Section 15G to the Exchange Act.

³² Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC; Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System; Mr. Alfred M. Pollard, General Counsel, Federal Housing Finance Agency; Office of the Comptroller of the Currency; Mr. Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation; Regulations Division, Office of General Counsel, Department of Housing and Urban Development, dated July 29, 2011 (“Risk Retention Comment Letter”), available at <http://www.ici.org/pdf/25368.pdf>.

³³ The legislative history for Section 15G of the Exchange Act states that “a ‘one size fits all’ approach to risk retention may adversely affect certain securitization markets Accordingly, the bill requires that the initial joint rulemaking include separate components addressing individual asset classes -- home mortgages, commercial mortgages, commercial loans, auto loans, and any other asset class that the regulators deem appropriate. The Committee expects that these regulations will recognize differences in the assets securitized, in existing risk management practices, and in the structure of asset-backed securities, and that regulators will make appropriate adjustments to the amount of risk retention required.” S. Rep. No. 111-176, at 130 (2010).

³⁴ Risk Retention Comment Letter, *supra* note 32.

sponsor and investor, making it unnecessary to impose further risk retention requirements on such bank-sponsored ABCP programs.

The proposal is silent regarding municipal TOB programs. A municipal TOB program is created by a sponsor bank that deposits one or more high-quality municipal bonds into a trust which issues two classes of tax-exempt securities: a short-term security that is supported by a liquidity facility and an inverse floating rate security. Tax-exempt money market funds are the principal holders of the short-term securities. ICI has requested clarification from the Regulators that TOBs are not within the scope of the proposal or, alternatively, that they be exempted from its requirements.³⁵ TOBs are distinguishable from traditional ABS and do not raise the concerns the risk retention requirements were intended to address. Applying the proposed risk retention requirements to TOBs would not be in the public interest. Furthermore, the structural characteristics of TOB programs would make it difficult for their sponsors to satisfy the proposed risk retention requirements. If TOB sponsors were forced to restructure their programs significantly to comply with the proposed rules' requirements, the increase in the cost of TOB program sponsorship could adversely affect the state and local governments that indirectly receive funding through these programs.

2. Prohibition Against ABS Conflicts of Interest

Last September, the SEC proposed a rule that would implement the prohibition under the Dodd-Frank Act against material conflicts of interest in connection with certain securitizations.³⁶ ICI generally supports the proposed rule, as it would serve to protect investors in ABS against certain conflicts of interest that may be raised by the activities of securitization participants.³⁷ At the same time, we are concerned that registered funds could fall within the proposed rule's scope because they may be affiliates of entities that structure or distribute ABS. Actions taken by a registered fund in connection with investing in ABS, through its investment adviser acting in a fiduciary capacity, do not raise the conflicts of interest the proposed rule seeks to address. The SEC should clarify that the proposed rule excludes such activities.

The proposed rule includes an exception for commitments to provide liquidity for an ABS, including those liquidity commitments provided by securitization participants in connection with notes issued by ABCP programs, which we support.³⁸ Certain restrictions under the regulatory proposal to implement the Volcker Rule (discussed in [Section II](#) above) could be interpreted, however,

³⁵ *Id.*

³⁶ *Prohibition against Conflicts of Interest in Certain Securitizations*, 76 Fed. Reg. 60320 (September 28, 2011). Proposed Rule 127B under the Securities Act of 1933 would implement the prohibition under Section 621 of the Dodd-Frank Act.

³⁷ See Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC, dated February 13, 2012, available at <http://www.ici.org/pdf/25907.pdf>.

³⁸ ABCP has unique characteristics that distinguish it from typical ABS, including liquidity facilities for the benefit of investors that often are provided by the sponsoring bank or one of its affiliates.

to prohibit such liquidity arrangements for bank-sponsored or advised programs, which would threaten the viability of such programs.³⁹ Such a result would be inconsistent with Congressional intent in enacting the exception for liquidity commitments, an exception set forth in the Dodd-Frank Act itself. Moreover, such a prohibition is not necessary to address the conflict of interest concerns against which the Volcker Rule was designed to protect.

B. Derivatives and Title VII of the Dodd-Frank Act

The implementation of the Dodd-Frank Act will dramatically change the derivatives markets, establishing a new regulatory framework for the swaps markets and their participants.⁴⁰ Registered funds are participants in these markets, and they use swaps and other derivatives in a variety of ways to manage their portfolios. For example, registered funds use derivatives to hedge positions; equitize cash that a fund cannot immediately invest in direct equity holdings; manage the fund's cash positions more generally; adjust the duration of the fund's portfolio; manage bond positions in general; or manage the fund's portfolio in accordance with the investment objectives stated in its prospectus. Relative to comparable cash securities, derivatives' potential benefits include the ability to:

- Hedge exposure to a market, sector, security, or other target exposure;
- Gain or reduce exposure to a market, sector, security, or other target exposure more quickly, more precisely, and/or with lower transaction costs and portfolio disruption;
- In some cases, utilize a more liquid alternative to traditional cash securities; and
- Gain access to markets in which transacting in cash securities is difficult, costly, or not possible.

Accordingly, ICI and its members have encouraged reform efforts in the derivatives markets.⁴¹ During the hearings that led to the Dodd-Frank Act, for example, ICI specifically supported measures that would increase transparency and reduce counterparty risk of certain over-the-counter derivatives.⁴² We, therefore, have urged the CFTC and the SEC to promulgate regulations in a manner that provides the protections sought by the Dodd-Frank Act while minimizing disruptions to the markets, market participants, and customers. In this regard, four issues are of particular concern to us: the

³⁹ ICI Volcker Comment Letter, *supra* note 3, at 39.

⁴⁰ Throughout this section of the testimony, we will use the term "swaps" to refer to both swaps and security-based swaps, unless the context requires otherwise.

⁴¹ See, e.g., ICI June 2011 Testimony, *supra* note 7. Testimony of Karrie McMillan, General Counsel, Investment Company Institute, before the Subcommittee on General Farm Commodities and Risk Management Committee on Agriculture, United States House of Representatives, on "Implementing Dodd-Frank: A Review of the CFTC's Rulemaking Process" (April 13, 2011) ("ICI April 2011 Testimony"), available at http://www.ici.org/pdf/11_cftc_rule4.5_exclude.pdf.

⁴² Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the U.S. House of Representatives Committee on Financial Services on "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals" (July 17, 2009), available at http://www.ici.org/govaffairs/testimony/09_reg_reform_jul_tmny.

implementation process for the final swaps rules; the status of non-deliverable foreign exchange forwards; the process for making a swap “available to trade;” and the determination of block trades.

1. Implementation of Title VII

The process of finalizing and implementing the rulemakings under Title VII of the Dodd-Frank Act must ensure that the new rules are tailored appropriately, work in tandem with one another, and strike the right balance between costs and benefits. ICI appreciates the extraordinary efforts the SEC and CFTC (together, the “Commissions”) have made in the very difficult task of developing rules to address the complexities of the swaps markets while avoiding unintended adverse consequences. To ensure that the final regulatory framework “gets it right,” however, it is crucial that the Commissions sustain a transparent and open rulemaking process, phase in the effective and compliance dates of the final rules in a logical manner, provide adequate time for market participants to transition to the new rules, and harmonize and coordinate with domestic and international regulators, as appropriate.

Implementation of the new regulatory framework must follow a sequential, deliberative and coordinated process to minimize unforeseen and unintended consequences for market participants, customers and the derivatives markets, including disruptions to the markets and risk mitigation strategies.⁴³ Specifically, the implementation periods should:

- Afford adequate time for the Commissions to gather additional market data to inform future rulemaking;
- Allow market participants to build market infrastructures, modify business operations, complete testing, and perform outreach and education of customers; and
- Phase in rule requirements by type of market participants and asset class.

Market participants are struggling with the implications of the new rules on their activities in these markets, and are hampered in developing compliance strategies by the need to wait for action from other market participants. Phasing in the rules will provide market participants with essential time to identify the cumulative impact of the rule changes, build upon the actions of other market participants, and manage the cumulative costs of the rule changes.

⁴³ See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, CFTC, dated November 4, 2011 (“November 2011 Implementation Letter”), available at <http://www.ici.org/pdf/25619.pdf>; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated June 10, 2011 (“June 2011 Implementation Letter”), available at <http://www.ici.org/pdf/25276.pdf>; and Letter from American Bankers Ass’n, ABA Securities Ass’n, The Clearing House Ass’n, L.L.C., Financial Services Forum, Financial Services Roundtable, Institute of International Bankers, International Swaps and Derivatives Ass’n, Investment Company Institute, Managed Funds Ass’n and Securities Industry and Financial Markets Ass’n to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated December 6, 2010, available at <http://www.ici.org/pdf/24780.pdf>.

ICI commends the Commissions for recognizing the importance of phasing in the rules in each of their proposals that address the sequencing of the compliance dates of the final swaps rules adopted under Title VII.⁴⁴ We are concerned, however, that the CFTC’s proposed schedules for phasing in compliance with the swaps rules significantly underestimate the time needed for the swap market to transition to the new framework. They also underestimate the time needed for the transition to take place in an orderly manner that does not disadvantage certain market participants and minimizes disruption to the marketplace.⁴⁵ In order to ensure a smooth, efficient, and effective transformation of the swaps markets, we believe the Commissions should provide a transition period of 18 to 24 months following adoption of final rules. The SEC’s recent statement on the anticipated sequencing of the compliance dates for the Title VII rules on security-based (“SB”) swaps explains the general order in which SB swap market participants might prepare for compliance with the final rules and discusses the sequencing of the rules in relation to one another.⁴⁶ ICI is in the process of evaluating this proposal, and expects to comment on it shortly. In addition to the comments we will have on the proposal itself, we believe it will be essential for the Commissions to harmonize and coordinate their approaches with one another. Similarly, to address the global nature of the derivatives markets, the Commissions’ rules should be finalized only after harmonizing requirements and principles with those rules being adopted by foreign regulators.⁴⁷ Where harmonization is not possible, coordination should be undertaken.

2. The Status of Non-Deliverable Foreign Exchange Forwards

Under the Dodd-Frank Act, foreign exchange (“FX”) swaps and forwards are considered swaps unless the Secretary of the Treasury makes a written determination that either or both should not be regulated as swaps.⁴⁸ In May 2011, the Treasury issued a proposed determination, which to date has

⁴⁴ See *Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 77 Fed. Reg. 35625 (June 14, 2012) (“Proposed SEC Implementation Statement”); *Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements under Section 4s of the CEA*, 75 Fed. Reg. 78176 (September 20, 2011); and *Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(b) of the CEA*, 75 Fed. Reg. 58186 (September 20, 2011).

⁴⁵ See November 2011 Implementation Letter, *supra* note 43.

⁴⁶ Proposed SEC Implementation Statement, *supra* note 44.

⁴⁷ We note that the CFTC recently proposed interpretive guidance on the cross-border application of Title VII. See *Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act*, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister062912.pdf>. The SEC has indicated that it will issue similar guidance in connection with SB swap transactions. Proposed SEC Implementation Statement, *supra* note 44, at 35631.

⁴⁸ Section 1a(47)(E) of the Commodity Exchange Act, as amended by the Dodd-Frank Act. These products, however, would remain subject to certain reporting requirements, and anti-fraud and business conduct standards under the Commodity Exchange Act.

not been finalized, that would exempt FX swaps and forwards from the definition of swap.⁴⁹ The Treasury's proposed determination would not include non-deliverable FX forwards ("NDFs") within the exemption. ICI has consistently supported Treasury's proposed exemption of FX swaps and forwards, and strongly believes that it should extend to NDFs.⁵⁰

An FX forward is a transaction to exchange two currencies at a future date at an exchange rate that is agreed upon at the time of entering into the transaction.⁵¹ An NDF is cash settled in just one currency and does not involve the exchange of underlying currencies. NDFs are used by market participants instead of FX forwards when a particular currency cannot be physically delivered because of currency controls or local law restrictions. NDFs are functionally and economically identical to deliverable FX forwards. They do not pose greater risk to market participants or the financial system.⁵² Whether the FX forward is deliverable or non-deliverable is not relevant to the market participant's investment decision. For these reasons, we recommend that Treasury, in coordination with the CFTC, or, if necessary, Congress, clarify that FX forwards include both deliverable FX forwards and NDFs. Failure to do so would result in operational difficulties for market participants when assessing their swaps activity for purposes of certain CFTC rules, could allow for potential arbitrage between the two types of FX forwards, and would increase fragmentation in the currency markets because NDFs would be subject to clearing and trading requirements, while FX forwards would not.

3. The Process for Making a Swap "Available to Trade"

Late last year, the CFTC, pursuant to the Dodd-Frank Act, proposed a process to establish which swaps will be subject to mandatory trading, or will be made "available to trade" on a designated contract market ("DCM") or swap execution facility ("SEF"), for purposes of the Commodity Exchange Act.⁵³ The CFTC's proposed process would grant the DCMs and SEFs themselves a significant role in making these determinations. In ICI's view, the proposed process clearly would not

⁴⁹ See *Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act*, 76 Fed. Reg. 25774 (May 5, 2011).

⁵⁰ See Letter from Karrie McMillan, General Counsel, Investment Company Institute, and Cecelia Calaby, Executive Director and General Counsel, ABA Securities Association, to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, and Mr. David A. Stawick, Secretary, Commodity Futures Trading Commission, dated July 22, 2011, available at <http://www.ici.org/pdf/25354.pdf>; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Mary J. Miller, Assistant Secretary for Financial Markets, United States Department of the Treasury, dated June 6, 2011, available at <http://www.ici.org/pdf/25254.pdf>; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Mary J. Miller, Assistant Secretary for Financial Markets, United States Department of the Treasury, dated November 29, 2010, available at <http://www.ici.org/pdf/24751.pdf>.

⁵¹ See Section 1a(24) of the Commodity Exchange Act, as amended by the Dodd-Frank Act.

⁵² See letters cited in note 50, *supra*.

⁵³ *Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available To Trade*, 76 Fed. Reg. 77728, (December 14, 2011).

provide the CFTC with a role sufficient to curb the financial incentives DCMs and SEFs will have to mandate prematurely the trading of swaps on their platforms.⁵⁴ If swaps are made “available to trade” prematurely, market participants would be required to trade that those swaps over a DCM or SEF, even in the absence of a liquid trading market for the swap. ICI believes strongly that only those swaps that are the most liquid should be subject to mandatory execution.

To address the incentives a DCM or SEF may have to make a swap “available to trade” prematurely, ICI recommends that the CFTC require DCMs and SEFs to consider objective standards or thresholds as part of the make “available to trade” (“MAT”) determination process, and that consideration of each standard/threshold be mandatory. We note that the SEC, which is subject to a similar requirement with respect to SB swaps, also has recognized that SEFs face a conflict of interest with respect to such determinations.⁵⁵ Accordingly, the SEC has stated that the MAT determination should be made “pursuant to objective measures established by the [SEC], rather than by one or a group of [security-based SEFs].”⁵⁶ We support the SEC’s approach to MAT determinations and recommend that the CFTC make its approach more consistent with that of the SEC.

4. The Determination of Block Trades

Pursuant to the Dodd-Frank Act, both the SEC and CFTC have issued proposals, and the CFTC has adopted rules, that would require, upon execution, reporting of swap transaction data to a registered swap data repository (“SDR”). The SDR would make certain of the swap data publicly available in real time. Market transparency is a key element to ensuring the integrity and quality of these markets,⁵⁷ but that must be balanced against the need to adequately protect information regarding a registered fund’s block trades.

⁵⁴ See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated February 13, 2012, available at <http://www.ici.org/pdf/25910.pdf>.

⁵⁵ The Dodd-Frank Act added an analogous provision to the Exchange Act applicable to transactions in SB swaps executed on an exchange or on an SB SEF. See Section 3C(h)(2) of the Exchange Act.

⁵⁶ *Registration and Regulation of Security-Based Swap Execution Facilities*, 76 Fed. Reg. 10948, 10970 (February 28, 2011); see also Proposed SEC Implementation Statement, *supra* note 44, at 35641.

⁵⁷ As part of its recommendations to the Commissions regarding the sequence for implementation of the new swaps regulatory framework, ICI has recommended that the Commissions begin by finalizing and implementing rules requiring reporting of swap transaction data to the regulators. Initially, reporting should be limited to non-public, regulatory reporting to gather data to inform, for example, block trading rules without significantly disrupting the swaps market and market participants’ trading strategies by impacting liquidity. ICI believes that the information gathered through this process will assist the Commissions in better understanding the structure and operations of the swaps markets and adopting appropriately tailored and effective rules. Further, only after such analysis can the Commissions accurately determine the effect of public dissemination of certain of the swap transaction data. See June 2011 Implementation Letter and November 2011 Implementation Letter, *supra* note 43.

Block trades are large transactions that are negotiated off an exchange's trading facility, and then posted on the trading facility. In the swaps markets, they enable registered funds, on behalf of their shareholders, to transact in large amounts with minimal disruption to the swaps market. Block trades also reduce the possibility that registered funds would be subject to the higher trading costs associated with large (non-block) transactions, costs that would be borne by funds and their shareholders. As explained below, flexible and anonymous block trading is essential given the swaps market's comparative lack of depth and liquidity.

After a block trade has been executed, one or more of the counterparties will seek to reduce risk by hedging its exposure, usually by transacting on an exchange. Knowledge of a block trade therefore signals to other market participants that there is the potential for subsequent trading activity.⁵⁸ This signaling can negatively affect the market and registered fund shareholders by significantly skewing pricing if the market does not have sufficient time to digest the block order. In addition, opportunistic market participants may piece together information about a registered fund's holdings or trading strategy, leading to front running of the fund's trades, which adversely impacts the price of the swap and the underlying security to the detriment of fund shareholders.

Failure adequately to protect registered funds' block trading strategies could compromise funds' sensitive trading data, enabling market participants to identify funds and their trading strategy to the detriment of funds, their shareholders and the liquidity of the market in which those trades occur. In response to a significant number of comments (including those of ICI), the CFTC recently repropose rules specifying the procedures for determining block trade sizes.⁵⁹ While ICI appreciates that the CFTC intended the reproposal to provide a more tailored approach than its original proposal, ICI remains deeply concerned that the proposed swap categories are too broad, grouping together swaps with vastly different liquidity profiles, and that the CFTC has proposed a calculation for determining minimum block trade size that would result in too high a threshold for block trades.⁶⁰ The SEC has yet to propose specific block trade thresholds, and has requested comment on various methods of establishing block trade thresholds, as well as other issues related to block trades.⁶¹ We recommend that the Commissions coordinate their proposals to the extent possible.

⁵⁸ In post-transaction analysis of block trades, our members report being able to see that the market tracked their movements.

⁵⁹ *Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades*, 77 Fed. Reg. 15460 (Mar. 15, 2012).

⁶⁰ See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, CFTC, dated May 14, 2012, available at <http://www.ici.org/pdf/26158.pdf>. The 67-percent notional amount calculation proposed by the CFTC for determining minimum block trade size would result in approximately 94 percent of trades being reported in real-time. We believe this calculation would set the minimum block thresholds too high, given the lack of depth and liquidity in the swaps markets, which could cause disruptions in these markets.

⁶¹ Proposed SEC Implementation Statement, *supra* note 44.

The best way to identify the appropriate thresholds for block trades in the swaps market is to account for the liquidity in each unique category of swaps.⁶² The risks, trading and liquidity associated with a particular swap differ for each individual swap category within an asset class based on type, term and underlying security. The Commissions should reflect these granular but significant differences by creating narrow buckets to which the threshold formulas would apply.⁶³ These thresholds should be calculated regularly (*e.g.*, quarterly or, at a minimum, semi-annually) to ensure that they are appropriately tracking liquidity in the swap categories.⁶⁴

In addition, the thresholds must be low enough to encourage the use of block trades. Setting the thresholds too high could cause significant market disruption and harm to registered fund shareholders by eliminating the use of block trades in these markets and the associated benefits provided by such trades.⁶⁵ Therefore, the Commissions should err on the side of caution by setting the thresholds low initially to collect data to enable them to evaluate the thresholds and the appropriate delays for data dissemination.

IV. CFTC RULE 4.5

While all of the issues discussed above are mandated by, or otherwise stem directly from, the Dodd-Frank Act, the CFTC's Rule 4.5 is an example of an agency using the Dodd-Frank Act as a pretext for an expansion of its authority through unjustified regulations.

Since its initial adoption almost thirty years ago, CFTC Rule 4.5 under the Commodity Exchange Act rule had provided a uniform exclusion from CFTC regulation as a commodity pool operator ("CPO") for entities that are already subject to another regulatory scheme. Among these entities are registered funds, which are comprehensively regulated by the SEC under all four of the major federal securities laws. On February 8, 2012, the CFTC adopted amendments to Rule 4.5.⁶⁶ The

⁶² Under the proposed CFTC thresholds, many transactions that should be treated as block trades would not qualify as such.

⁶³ We acknowledge that the CFTC has attempted to do this to a greater extent in its reproposal; however, the proposed categories appear to continue to group together swaps of a wide range of liquidities. We recommend that the CFTC analyze the data it will receive from SDRs to provide more granular categories within the interest rate and credit default swap asset classes to more accurately reflect liquidity and to determine whether further refinements are necessary for the FX and other commodity asset classes. We also disagree with the CFTC's proposal not to treat any trades in equity swaps as block trades, and believe the CFTC should propose an appropriate minimum block size for such equity swaps.

⁶⁴ We therefore believe the CFTC's proposal to set minimum block sizes annually would be too infrequent and that the thresholds must be calculated more regularly to reflect changes in the market.

⁶⁵ As noted above, we are concerned that the CFTC's proposed 67-percent notional amount calculation would result in too high a threshold for block trades. We instead recommend that the CFTC adopt the 50-percent notional amount calculation that was suggested by the CFTC as an alternative approach and to phase-in this standard over a period of time for very illiquid categories of swaps. *See supra* note 60 and accompanying text.

⁶⁶ *See Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations*, 77 Fed. Reg. 11252, 11253 (Feb. 24, 2012); *correction notice published at* 77 Fed. Reg. 17328 (Mar. 26, 2012) ("Rule 4.5 Adopting Release").

CFTC’s amendments sharply curtail the Rule 4.5 exclusion, but *only* for registered funds and not for other entities covered by the rule.

Under amended Rule 4.5, any registered fund that engages in more than a *de minimis* level of investment in commodity futures, commodity options or swaps or that does not satisfy the rule’s restrictions on marketing will not qualify for the exclusion. In that case, the registered fund’s investment adviser will have to become registered with the CFTC as a CPO, in addition to being registered with the SEC. And the registered fund and its adviser will become subject to the CFTC’s separate regime of disclosure, reporting, and recordkeeping, as well as to regulation and oversight by the National Futures Association (“NFA”).

This additional regulation is altogether unnecessary and redundant of the comprehensive regulation to which registered funds and their advisers are already subject by the SEC. The CFTC has neither justified the need for these additional regulatory burdens, nor the significant costs the rule will impose on registered funds—costs that ultimately will be borne by their shareholders. Nor has the agency adequately explained how registered fund shareholders, which already enjoy comprehensive protections under the federal securities laws, will benefit from this additional, redundant layer of regulation.

The CFTC attempts to justify its action by pointing to the 2008 financial crisis and passage of the Dodd-Frank Act, saying that the statute gives it a “more robust mandate” to “manage systemic risk” in the derivatives markets.⁶⁷ In fact, the amendments to Rule 4.5 were neither required nor even contemplated by the Dodd-Frank Act.⁶⁸ We agree with the observations made by CFTC Commissioner Jill Sommers, whose dissent in this rulemaking criticized the agency’s rationalization as unpersuasive:

... Congress was aware of the existing exclusions and exemptions for CPOs when it passed Dodd-Frank and did *not* direct the Commission to narrow their scope or require reporting for systemic risk purposes. The Commission justifies the new rules as a response to the financial crisis of 2007 and 2008 and the passage of Dodd-Frank, yet there is *no evidence* to suggest that inadequate regulation of commodity pools was a contributing cause of the crisis, or that subjecting entities to a dual registration scheme will somehow prevent a similar crisis in the future.”⁶⁹

⁶⁷ Commodity Futures Trading Commission, Cross-Motion for Summary Judgment, Opposition to Plaintiffs’ Motion for Summary Judgment, and Motion to Dismiss in Part at 12, *Investment Company Institute, et al. v. CFTC*, Case No. 1:12-cv-00612 (D.D.C. June 18, 2012) (quoting Rule 4.5 Adopting Release, *supra* note 66, at 11275).

⁶⁸ The CFTC also has described the amendments as being “consistent with the tenor of the provisions of the Dodd-Frank Act,” despite *nothing* in the statute even remotely alluding to the need for CFTC oversight of registered funds. Rule 4.5 Adopting Release, *supra* note 66.

⁶⁹ See Commissioner Jill E. Sommers, *Dissenting Statement, Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations* (February 9, 2012), available at

Similar cautions were raised *prior* to the CFTC’s adoption of the amendments. In particular, Chairman Jack Kingston repeatedly expressed his concern to CFTC Chairman Gensler that the then-proposed Rule 4.5 amendments were not mandated by the Dodd-Frank Act, and urged that the rulemaking be delayed until major rulemakings required by Dodd-Frank were completed.⁷⁰ Indeed, the CFTC in this rulemaking disregarded the plain recommendations of members of this Congress that it focus on its actual Dodd-Frank mandate.⁷¹

Also troubling is the fact that the CFTC failed to perform even the most rudimentary cost-benefit analysis. Last year, Chairmen Kingston and Conaway alerted the CFTC to their concerns that costs associated with the proposed changes to Rule 4.5 “will likely result in higher costs for many of our constituents that have invested their savings in investment plans that have exposure to the futures markets.”⁷² And as recently as January of this year—one month before the CFTC’s vote to approve the amendments—the two Chairmen stated that they “remain opposed to the promulgation of this rule without a thorough cost-benefit analysis because the proposed rule has the potential to create duplicative, unnecessary regulations.”⁷³ These concerns were not heeded, and the CFTC adopted the amendments to the rule with only a cursory analysis that failed to meaningfully assess the rule’s impact. Commissioner Sommers observed in her dissent that the CFTC’s cost-benefit analysis of the rule was “sorely lacking.”⁷⁴

Perhaps most regrettable, in ICI’s view, is the fact that the CFTC failed to address the significant concerns raised, and specific recommendations offered, by the public through consideration of this rulemaking. ICI and our members made every effort to advocate for a more sensible outcome.

<http://www.cftc.gov/PressRoom/SpeechesTestimony/sommersstatement020912a> (“Sommers Dissenting Statement”) (emphasis added).

⁷⁰ See Letter from Chairman Jack Kingston, Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, Committee on Appropriations, U.S. House of Representatives, and Chairman K. Michael Conaway, Subcommittee on General Farm Commodities and Risk Management, U.S. House of Representatives, to the Honorable Gary Gensler, Chairman, CFTC, dated January 30, 2012 (“2012 Kingston and Conaway Letter”); Letter from Chairman Jack Kingston, Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, Committee on Appropriations, U.S. House of Representatives, Chairman K. Michael Conaway, Subcommittee on General Farm Commodities and Risk Management, U.S. House of Representatives, and Congressman Bill Owens, U.S. House of Representatives, to the Honorable Gary Gensler, Chairman, CFTC, dated October 3, 2011 (“2011 Kingston, Conaway, and Owens Letter”).

⁷¹ See Letter from Frank D. Lucas, Chairman, Committee on Agriculture, and K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk Management, to the Honorable Gary Gensler, Chairman, U.S. Commodity Futures Trading Commission, dated July 14, 2011 (“In light of the volume of rules that are required by Title VII, it is prudent to prioritize the time and resources of your staff. We recommend that you promulgate rules that are required before moving to rules that are not explicitly required by Dodd-Frank.” (going on to describe Rule 4.5)).

⁷² 2011 Kingston, Conaway, and Owens Letter, *supra* note 70.

⁷³ 2012 Kingston and Conaway Letter, *supra* note 70.

⁷⁴ Sommers Dissenting Statement, *supra* note 69.

ICI filed three detailed comment letters; met with CFTC commissioners and staff; participated in the CFTC staff's public roundtable; and testified on Capitol Hill about this rulemaking.⁷⁵ Twelve of our member firms also filed comments.

ICI strives to work cooperatively within the administrative process to help regulators craft rules that are effective, efficient, and equitable. Unfortunately, we could not reach that outcome in this instance, and our mission—to advance the interests of registered funds, their shareholders, directors, and advisers—led us to conclude that our only recourse was to challenge the CFTC's action in court. Accordingly, we joined with the U.S. Chamber of Commerce in April to file a legal challenge to the adoption of the Rule 4.5 amendments.⁷⁶ The briefing in the litigation is almost complete, and we are hopeful that a decision will be issued by the court sometime this fall.

If our challenge is unsuccessful and the amendments to Rule 4.5 are upheld in court, it is important for this Subcommittee to be aware of the considerable long-term implications this rulemaking will have, not only for registered funds and their shareholders, but for the CFTC. A host of new registrants will increase the agency's workload, and regulatory oversight of these new registrants will place further demands on the CFTC's limited resources, at a time when the agency acknowledges that it cannot meet new responsibilities under the Dodd-Frank Act.⁷⁷ In fact, the CFTC's recent performance plan states that the redeployment of resources necessary to address “the surge of Dodd-Frank registrations and reviews . . . creates risks in its critical oversight roles.”⁷⁸ The Rule 4.5 amendments likewise will strain the resources of the NFA, which serves as the frontline regulator for CPOs.

V. CONCLUSION

I appreciate the opportunity to share these views with the Subcommittee. ICI looks forward to working with Congress and regulators on these and other issues as implementation of the Dodd-Frank Act continues.

⁷⁵ See Letters from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, CFTC, dated October 18, 2010, April 12, 2011 and July 28, 2011, available at <http://www.ici.org/pdf/24625.pdf>, http://www.ici.org/pdf/11_cftc_rule4.5_exclude.pdf, and http://www.ici.org/pdf/12_com_ltr_cftc_rdtble.pdf, respectively; ICI April 2011 Testimony, *supra* note 41.

⁷⁶ See Complaint, *Investment Company Institute, et al. v. CFTC*, Case No. 1:12-cv-00612 (D.D.C. Apr. 17, 2012).

⁷⁷ See Testimony of the Honorable Gary Gensler, Chairman, Commodity Futures Trading Commission, Before the U.S. Senate Appropriations Subcommittee on Financial Services and General Government (March 21, 2012) (stating that “effectively overseeing these markets depends on adequate funding for the agency’s expanded mission.”).

⁷⁸ Commodity Futures Trading Commission, *President’s Budget and Performance Plan, Fiscal Year 2013*, Prepared for the Committee on Appropriations (February 2012) (emphasis added).