INVESTMENT COMPANY INSTITUTE

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December 21, 2012

VIA ELECTRONIC MAIL

Daniel A. Driscoll
Executive Vice President,
Chief Operating Officer

Thomas W. Sexton, III
Senior Vice President,
General Counsel and Secretary

National Futures Association
300 S. Riverside Plaza, #1800
Chicago, Illinois 60606-6615

Re: NFA Compliance Rule 2-45

Dear Mr. Driscoll and Mr. Sexton:

The Investment Company Institute ("ICI")[1] seeks confirmation on behalf of its members[2] that transactions permitted by exemptive orders and no-action letters issued by the Securities and Exchange Commission and its staff under Section 17 of the Investment Company Act of 1940 ("Investment

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.8 trillion and serve over 90 million shareholders.

[2] As a result of the Commodity Futures Trading Commission's ("CFTC") recent amendments to Regulation 4.5, many registered investment advisers that advise registered investment companies must register as commodity pool operators ("CPOs"). Although ICI has judicially challenged amended Regulation 4.5, see Complaint, Investment Company Institute, et al. v. CFTC, Case No. 1:12-cv-00612 (D.D.C. Apr. 17, 2012), it is committed to assisting its members' efforts to comply with the amended regulation.

Company Act") will be deemed not to implicate National Futures Association ("NFA") Compliance Rule 2-45, which prohibits loans by a commodity pool to a CPO or other affiliated person or entity.[3]

Section 17 and other provisions of the Investment Company Act also prohibit these transactions, based on the same principles underlying Compliance Rule 2-45. Pursuant to exemptive relief and/or no-action letters issued by the Securities and Exchange Commission ("SEC") and its staff, however, registered investment companies ("funds") are permitted to engage in certain transactions that could potentially implicate Compliance Rule 2-45, subject to specific conditions that are designed to address the concerns shared by the SEC and NFA. Because the conditions imposed on such transactions by the SEC and its staff address the shared concerns of both regulators, we request that you confirm that the NFA would deem transactions permitted by these SEC exemptive orders and no-action letters not to implicate Compliance Rule 2-45. Our analysis is discussed in more detail below.

<u>The Concerns Underlying Section 17 and other Investment Company Act Provisions and Compliance Rule 2-45 are Substantially Similar</u>

Section 17, along with other provisions of the Investment Company Act that restrict transactions between funds and their affiliates, is intended to prevent self-dealing and other forms of overreaching of a fund by its affiliates. For example, Section 17(a) of the Investment Company Act generally prohibits an affiliated person, or an affiliated person of an affiliated person, of a fund (a "second-tier affiliate"), acting as principal, from knowingly purchasing from the fund any security or other property. This section protects investors by prohibiting a purchase or sale transaction when a party to the transaction has both the ability and the pecuniary incentive to influence the actions of the fund. Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder generally prohibit an affiliated person or second-tier affiliate of a fund, acting as principal, from participating in any joint enterprise, joint arrangement, or profit-sharing plan, as defined in the rule, without first obtaining an order from the SEC. These provisions are intended to protect investment companies from participating in transactions with affiliated persons on inequitable terms. Section 17(f) of the Investment Company Act governs the custody of a fund's assets, including its portfolio securities. It requires a fund to maintain its securities and other investments with certain types of custodians (*e.g.,* banks and members of national securities exchanges) under conditions designed to assure the safety of the fund's assets.

Compliance Rule 2-45 shares similar premises.[4] As the NFA explained in its letter to the CFTC proposing adoption of the rule and interpretive guidance, it had encountered multiple instances of CPOs "misappropriating pool participant funds through direct or indirect loans from a pool to the

[3] We are requesting similar relief from the CFTC with respect to its Regulation 4.20(c), which prohibits commingling by a CPO of the property of any pool it operates with the property of any other person.

[4] Compliance Rule 2-45 provides that "[n]o Member CPO may permit a commodity pool to use any means to make a direct or indirect loan or advance of pool assets to the CPO or any other affiliated person or entity."

CPO or a related entity."[5] As discussed further below, while Section 17 is designed to address the same types of concerns as Compliance Rule 2-45, the SEC and its staff have deemed it appropriate to grant relief to funds from the prohibitions of Section 17 under certain circumstances that do not raise these concerns.

The SEC Staff Has Provided Relief for Certain Transactions by Funds Otherwise Prohibited by Section 17

Like other regulators, the SEC has rigorous processes in place for offering relief from the rules it promulgates and enforces, in the form of exemptive orders and no-action letters. Section 6(c) of the Investment Company Act grants the SEC the authority to provide exemptions from any provision of the Act or from rules or regulations thereunder if "such exemption is necessary or appropriate in the public interest and consistent with the protection of investors…." Before granting exemptive orders, the SEC publishes a notice to the public regarding the proposed order and provides an opportunity for public comment. No-action letters, while provided by the SEC staff rather than the Commission and not subject to public comment, involve a similar legal analysis. Specifically, they analyze the particular facts and circumstances involved, discuss applicable laws and rules, and conclude that the SEC staff would not recommend that the Commission take enforcement action against the requester based on the facts and representations provided. Both exemptive orders and no-action letters typically include conditions to which the applicant has agreed that are designed to address the concerns underlying the laws or rules from which relief is being provided.

Through these processes, the SEC (or its staff) has carefully considered and determined to permit a number of arrangements that might otherwise violate Section 17 of the Investment Company Act, on the grounds that under specified conditions such arrangements do not raise the concerns underlying that section, and are in the public interest and consistent with the protection of investors.

For example, the SEC has provided exemptive relief to a number of fund complexes seeking to engage in inter-fund lending agreements to meet short-term, temporary cash needs. Absent relief, such arrangements would potentially violate Section 17(a)(3) of the Investment Company Act, which generally prohibits an affiliate of a fund from borrowing money or other property from the fund, and Section 21(b) of the Investment Company Act, which prohibits a fund from lending money or other property to any person that controls or is under common control with the fund. These arrangements also could potentially implicate Compliance Rule 2-45.

As the exemptive applications make clear, inter-fund lending arrangements can benefit both the borrowing and lending funds. That is, a lending fund may earn more from lending to an affiliated fund than from other forms of short term loans such as repurchase agreements ("repos"), while a borrowing

[5] Letter to David Stawick, Office of the Secretariat, Commodity Futures Trading Commission, from Thomas W. Sexton, Senior Vice President and General Counsel, National Futures Association, dated Aug. 26, 2009.

fund can borrow at a lower cost than by drawing on its bank line of credit ("bank loans"). The conditions set forth in the exemptive applications ensure that inter-fund loans only occur in circumstances that are favorable to both funds, and not in circumstances when an affiliate might cause a fund to engage in transactions that are detrimental to the interest of one of the funds. The conditions also include protections for both the borrowing and lending funds that are equivalent to protections in market-based borrowing/lending transactions.

As an example, conditions in some recent inter-fund lending orders include, among others, that: (1) the inter-fund loan rate will be the average of the repo rate and the bank loan rate; (2) an inter-fund loan will only be used if the rate is more favorable to both the borrowing and lending funds; (3) inter-fund loans to funds that have outstanding borrowings will be secured on at least an equal priority basis with at least an equivalent percentage of collateral to loan value as outstanding bank loans; (4) both borrowing and lending funds are limited in the amount they can borrow or lend through inter-fund arrangements; and (5) the board of trustees or directors of each fund, including a majority of independent board members, will review at least quarterly the participation of each fund in the inter-fund lending agreement, will establish the interest rate formula, and will review it at least annually.[6] While other exemptive orders and no-action letters may contain different conditions, they would similarly be designed to address the concerns against which Section 17(a)(3) and Section 21(b) were meant to protect. Any such conditions would supplement requirements that funds maintain required books and records and that funds undergo an annual audit of their financial statements. Moreover, when the SEC staff conducts an examination of a fund or fund family, it will typically assess compliance with the conditions or representations in exemptive applications or no-action letters relied on by the fund.

We believe these and other conditions established by the SEC address the concerns underlying Compliance Rule 2-45. We therefore request confirmation that funds engaging in transactions pursuant to exemptive orders or no-action letters provided by the SEC will be deemed not to implicate Compliance Rule 2-45.

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[6] *See, e.g., John Hancock Variable Insurance trust, et al.,* Investment Company Act of 1940 Release Nos. 29865 (Nov. 18, 2011) (notice) and 29885 (Dec. 14, 2011) (order); *MFS Series Trust I. et al.,* Investment Company Act of 1940 Release Nos. 29827 (Sept. 30, 2011) (notice) and 29849 (Oct. 26, 2011) (order); *Principal Funds Inc., et al.*, Investment Company Act of 1940 Release Nos. 29824 (Sept. 29, 2011) (notice) and 29843 (Oct. 25, 2011) (order).

We sincerely appreciate the willingness of the NFA staff to address the industry's concerns. If you have questions or require further information, please contact me at 202/326-5815, Sarah A. Bessin at 202/326-5835, or Mara L. Shreck at 202/326-5923.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

CC: Gary Barnett, Director
Amanda Olear, Special Counsel
Michael Ehrstein, Attorney-Advisor

Division of Swap Dealer and Intermediary Oversight
Commodity Futures Trading Commission

Norm Champ, Director
Jennifer McHugh, Senior Advisor to the Director
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Division of Investment Management
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