INVESTMENT COMPANY INSTITUTE

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September 28, 2017

Mr. Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Project KISS (RIN 3038-AE55)

Dear Mr. Kirkpatrick:

The Investment Company Institute[1] commends the Commodity Futures Trading Commission for undertaking its "Project Kiss" initiative to determine how the Commission's rules, regulations, or practices can be applied in a simpler, less burdensome manner.[2] ICI and its members have a strong interest in the CFTC and its staff rationalizing CFTC rules to reduce unnecessary burdens on market participants, particularly by recognizing the critical differences between registered investment companies ("registered funds") and traditional participants in the commodity markets. As participants in the derivatives markets, registered funds support regulation designed to maintain orderly, competitive, and efficient derivatives markets. Derivatives are a particularly useful portfolio management tool in that they offer registered funds considerable flexibility in structuring their investment portfolios.[3]

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[1] ICI is a leading global association of regulated funds, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$20.4 trillion in the United States, serving more than 95 million US shareholders, and US$6.7 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] *Project Kiss*, 82 Fed.Reg. 23765 (May 24, 2016), *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2017-10622a.pdf.

[3] A registered fund uses derivatives, among other things, to hedge positions, equitize cash, adjust the duration of its portfolio, and generally manage the portfolio in accordance with the investment objectives stated in its prospectus.

Registered funds are subject to CFTC regulation in two separate capacities. First, funds are buy-side participants in the derivatives market and are subject to rules such as the clearing mandate and the trading obligation. Second, registered funds are subject to CFTC regulation as a result of the CFTC's 2012 amendments to Regulation 4.5 under the Commodity Exchange Act (CEA), which required many registered fund advisers to register with the CFTC as commodity pool operators (CPOs).

We welcome this opportunity to provide our recommendations as the Commission reconsiders the application of its rules. We believe our recommendations are consistent with the agenda Chairman Giancarlo recently articulated for the CFTC,[4] particularly his goals of:

- Reducing regulatory burden, consistent with President Trump's executive orders;[5]
- Returning the CFTC to "regular order," and
- Resetting the CFTC's focus on its core mission, including leveraging its cooperation with parallel federal market regulators such as the Securities and Exchange Commission.

We recognize that some of our recommendations may, or would, require the Commission to engage in rulemaking. We discuss those issues in our letter, however, because we believe they are critical issues for the Commission's further consideration, and hope this discussion will be the beginning of a further and more in-depth dialogue.

We have organized our recommendations, below, according to each of the topics on which the Commission seeks comment.[6] For your convenience, our attached recommendations are summarized briefly below:

- **The CFTC should amend Regulation 4.5 to eliminate unnecessary regulatory overlap for registered funds and their advisers.** The CFTC should amend the rule to exclude registered funds advisers from being treated as CPOs, just as they were immediately prior to the rule's 2012

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[4] Acting Chairman J. Christopher Giancarlo, *CFTC: A New Direction Forward, Remarks before the 42nd Annual International Futures Industry Conference,* Boca Raton, Florida (March 15, 2017), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-20.

[5] *See* Exec. Order, Reducing Regulation and Controlling Regulatory Costs (Jan. 30, 2017), *available at* https://www.whitehouse.gov/the-press-office/2017/01/30/presidential-executive-order-reducing-regulation-and-controlling; *see also* Exec. Order, Enforcing the Regulatory Reform Agenda (Feb. 24, 2017), *available at* https://www.whitehouse.gov/the-press-office/2017/02/24/presidential-executive-order-enforcing-regulatory-reform-agenda.

[6] Consistent with the electronic filing requirements, we are filing this cover letter, along with an Appendix that corresponds to the topic of the respective Commission filing portal (registration, reporting, clearing, executing). *See* https://comments.cftc.gov/KISS/KissInitiative.aspx.

amendments.

- **Until the CFTC amends Regulation 4.5, it should take a substituted compliance approach to regulating registered fund CPOs and CTAs.** We suggest that the CFTC and its staff take a pragmatic, outcomes-based substituted compliance approach to addressing regulatory overlap for registered fund CPOs and CTAs in areas that were not adequately addressed by harmonization, and take such an approach as new issues arise in the future. We provide, as examples, Forms CPO-PQR and CTA-PR, liquidation statements, and recordkeeping.

- **The CFTC should adopt its rulemaking proposal that would provide relief to CPOs and CTAs acting on behalf of non-US persons.** We urge the CFTC promptly to adopt its 2016 rulemaking proposal that would, among other things, amend Regulation 3.10(c)(3) to eliminate unnecessary conditions, consistent with prior staff no-action relief.

- **The CFTC should amend its definition of "US person" to exclude certain non-US funds**. For purposes of the cross-border application of the CFTC's swaps provision, the CFTC should exclude from its definitions of "US person" non-US regulated funds that are authorized to be publicly offered to non-US persons but are not offered publicly to US persons.

- **The CFTC should retain the strong asset protections for cleared swaps provided by the "LSOC" model.** As the CFTC considers any recommendations for reform it may receive in the clearing area, we urge it to retain the "legal segregation with operational commingling," or LSOC, model for the protection of customer collateral and extend these protections to other cleared derivatives.

- **The CFTC should strengthen the process for making a swap "available to trade."** The CFTC should engage in a rulemaking that would address the risks and weaknesses inherent in the current "made available to trade," or MAT, process. We recommend that this process ensure that only those swaps that are liquid enough to support mandatory execution on a swap execution facility or designated contract market become MAT.

We also share Chairman Giancarlo's interest in reforming the CFTC's swap trading rules to foster a vibrant and liquid swaps market. To that end, we are preparing a separate letter—that we expect to submit soon—which will contain a set of recommendations designed to improve swaps trading.

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We appreciate the Commission's consideration of our recommendations. If you have questions or require further information, please contact me at (202) 218-3563, Sarah Bessin at (202) 326-5835, Jennifer Choi at (202) 326-5876, or Rachel Graham at (202) 326-5819.

Sincerely,

/s/ Dorothy M. Donohue

Dorothy M. Donohue
Acting General Counsel

cc: The Honorable J. Christopher Giancarlo
The Honorable Brian D. Quintenz
The Honorable Rostin Benham

Matthew B. Kulkin, Director
Division of Swap Dealer and Intermediary Oversight
Commodity Futures Trading Commission

Thomas W. Sexton, III, President and CEO
Regina G. Thoele, Senior Vice President, Compliance
National Futures Association

Appendix: Clearing Recommendation

Recommendation: The CFTC Should Retain the Strong Asset Protections for Cleared Swaps Provided by the "LSOC" Model

Background: As fiduciaries to their clients, registered fund advisers seek strong protections for fund swap collateral when registered funds trade in the derivatives markets. Registered funds also must ensure that their collateral arrangements satisfy the custody restrictions of the Investment Company Act of 1940.[1] To achieve these objectives, registered funds that transact in uncleared swaps currently use tri-party arrangements to hold the collateral that they post to their counterparties. These arrangements subject their margin to neither the fraud risk of the futures commission merchant (FCM) nor fellow-customer risk. For cleared swaps, collateral of registered funds is protected from fellow-customer risk through the CFTC's "legal segregation with operational commingling," or LSOC model.[2] Consistent with the requirements of Section 724 of the Dodd-Frank Act, LSOC provides critical protections to the customer collateral of registered funds and other market participants when they post collateral with FCMs and DCOs.

Recommendation: As the CFTC considers any recommendations for reform it may receive in the clearing area, we urge the Commission to retain the LSOC model for the protection of customer collateral and extend these protections to other cleared derivatives. LSOC provides critical protections to collateral posted for cleared swap transactions by registered funds and other market participants, and thereby provides the assurance they need to utilize cleared swaps as a portfolio management tool.

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[1] Under the Investment Company Act, registered funds are required to custody their assets in accordance with Section 17 of the Investment Company Act. Nearly all registered funds use a US bank custodian for domestic securities although the Investment Company Act permits other limited custodial arrangements. In addition to Section 17, the Investment Company Act contains six separate custody rules for the different types of possible custody arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self-custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories). Foreign securities are required to be held in the custody of a foreign bank or securities depository. Rule 17f-1 permits registered funds to use a broker-dealer custodian, but the rule imposes conditions that are difficult in practice to satisfy.

[2] *Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions*, 77 Fed. Reg. 6336 (Feb. 7, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-02-07/pdf/2012-1033.pdf. The LSOC model requires each FCM and derivatives clearing organization (DCO) to segregate on its books and records the cleared swaps of each individual customer and related collateral position. *See* 17 C.F.R. § 22.2 and 22.3 (2014). Each FCM and DCO is permitted to commingle customer collateral in one account. *See* 17 C.F.R. §22.2(c) (2014). FCMs and DCOs are also required to keep separate customer collateral from any account holding FCM or DCO property. *See* 17 C.F.R. § 22.2 and 22.3 (2014). Additionally, under the CFTC's rules, a clearinghouse may not allow the DCO to access the collateral of non-defaulting cleared swap customers to address losses of a defaulting swap customer in the event of a default of the clearing member (i.e., a "double default").