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Rule 4.5: Mutual Funds and Their Investors Benefit from Commodity Investments and Other Derivatives

In 2003, the CFTC changed Rule 4.5 to encourage "otherwise regulated" investment funds, such as mutual funds and exchange traded funds (ETFs), to participate in the futures markets, benefitting shareholders and the markets. Now with its 2012 amendment to Rule 4.5, the CFTC has done an about face by subjecting potentially hundreds of funds and their advisers to redundant and burdensome regulation that will either drive up shareholder costs or drive funds away from the use of these derivatives. In either case, shareholders lose.

This raises the question: *Why do registered investment companies like mutual funds and ETFs use options, futures, swaps, and other derivatives?*

To help investors diversify their holdings

- **Derivatives:** Funds use options, futures, swaps, and other derivatives to provide exposure to the commodity markets for those shareholders who seek that diversification.
- **Foreign markets:** Funds can use total return swaps to provide investors exposure to non-U.S. markets that may be difficult or costly to access.

To manage portfolios efficiently

Options, futures, swaps, and other derivatives give funds considerable flexibility in structuring their investment portfolios. Like many other investment vehicles, funds use these instruments in a variety of ways.

One important use is managing cash. Stock index futures and swaps, for example, offer funds the ability to achieve an index-based return while keeping cash available to meet redemptions, preventing "cash drag" on a fund's performance.

To lower costs

Often funds can establish a position using derivatives at lower cost than through buying underlying securities. Futures on Treasury notes, for example, can help fixed income funds adjust the duration of a fixed income portfolio without buying or selling bonds, which can be very expensive.

To manage risks

As one example, interest rate swaps allow portfolio managers to manage the interest rate risk of the fund with minimal transaction costs. The most common use might be in bond funds, where managers use interest rate swaps to cost effectively adjust the duration of their funds' portfolio.