

CFTC's Rule 4.5 is Government Regulation at Its Worst: A Flawed Process Produces a Flawed Rule that Increases Investors' Costs

CFTC's Rule 4.5 is an example of the regulatory process at its worst. The rule that the Commodities Futures Trading Commission (CFTC) has enacted is expected to require hundreds of advisers to registered investment companies, such as mutual funds and exchange traded funds (ETFs), to register and face redundant, conflicting regulatory burdens as commodity pool operators (CPOs). The CFTC's Rule 4.5 amendments serve as the latest example of a flawed regulatory process that produces a flawed result that ultimately harms investors. The agency followed a path of well-known regulatory missteps, including failure to conduct adequate cost-benefit analysis; an abrupt, unexplained course reversal; actions that put the cart before the horse; creating an unlevel playing field; and ignoring the impact of the rule on investors.

Regulatory disconnect #1: [Failure to conduct adequate cost benefit analysis](#) leaves little justification for the rule.

- The CFTC issued its final amendments to Rule 4.5 without conducting appropriate cost-benefit analysis. The agency has a statutory duty to consider the costs and benefits of regulations it adopts, including the regulation's effects on efficiency and competition. It failed to meet that standard, admitting in many cases that it had no data to back up its decisions. Yet rather than seek the data, the CFTC simply offered unsupported assertions about costs and benefits.
 - The CFTC did not examine the current regulatory requirements for mutual funds and ETFs to determine whether the proposed CFTC rule would bring additional benefits to investors.
 - The CFTC did not determine the rule's likely costs and even admitted that it lacked information necessary to perform cost analysis.
 - The CFTC did not quantify the benefits it claimed would result from its amendments.
 - Yet even with this fleeting approach to cost benefit analysis, the CFTC nonetheless proclaimed that Rule 4.5 somehow justifies its costs.
- CFTC Commissioner Jill Sommers disagreed with the final Rule 4.5, questioning the agency's process. In her [dissent](#), she said, "It is unlikely, in my view, that the cost-benefit analysis supporting the rules will survive judicial scrutiny if challenged."
- The CFTC's weak approach to cost-benefit analysis has been an issue before. A letter from Congress to the CFTC's Inspector General said, "[T]he CFTC has taken a vague and minimalist approach to cost-benefit analysis..."

Regulatory disconnect #2: An abrupt, unexplained course reversal means that yesterday's virtue is today's vice.

- In 2003, the CFTC amended Rule 4.5 to exclude all “otherwise regulated entities”, including registered investment companies, from regulation as CPOs. The reasons for doing so, as articulated by the CFTC, included:
 - Recognition that entities eligible to rely on Rule 4.5 are “otherwise regulated” by the SEC
 - Market developments and changes in the current investment environment;
 - The need to allow “greater flexibility and innovation” and to “encourage and facilitate” participation in the commodity markets by collective investment vehicles “with the added benefit of increased liquidity.”
- In reversing course, the CFTC did not explain why the advantages of funds’ participation in the futures markets that the agency cited in 2003 are no longer appropriate in 2012. The agency did not explain why SEC regulation of registered investment companies was no longer sufficient or that the benefits of increased liquidity no longer justified the exclusion from CFTC regulation.

Regulatory disconnect #3: Actions that put the cart before the horse create a confused and confusing rule.

- Under the Dodd-Frank Act, the CFTC and the SEC are charged with defining the term “swap” and that rulemaking is not completed. Yet, in a classic case of putting the cart before the horse, the CFTC decided to include use of swaps in the criteria that could sweep an adviser to a registered investment company into CFTC regulation. Without the swap rules in place, it is impossible to know how many advisers to funds will be required to register as CPOs as a result of Rule 4.5. It’s certain, however, that many more funds and their advisers will be affected than were under the 2003 version of Rule 4.5.

Regulatory disconnect #4: Creating an unlevel playing field.

- The CFTC claimed that the Rule 4.5 proposal was necessary to “ensure consistent treatment of operators of commodity pools regardless of their status with other regulators.”
- But the Rule 4.5 amendments apply only to registered investment companies – singling them out for additional burdensome regulation. Meanwhile, insurance companies, banks and pension plans may continue to operate in the same manner in the commodity markets without additional CFTC oversight.

Regulatory disconnect #5: The CFTC is ignoring the real consequences for investors.

- Before imposing these additional regulatory requirements on funds, the CFTC failed in its duty to consider whether its regulations would offer additional protections that existing SEC regulations do not.
- Requiring registered investment companies and their advisers to comply with redundant regulatory requirements beyond current SEC regulations is burdensome and raises [costs for investors](#).