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STATEMENT OF THE INVESTMENT COMPANY INSTITUTE ON THE U.S. COMMODITY FUTURES TRADING COMMISSION'S APPROPRIATIONS FOR FISCAL YEAR 2015

Subcommittee on Agriculture, Rural Development,
Food and Drug Administration, and Related Agencies
Committee on Appropriations
U.S. House of Representatives

March 6, 2014

Members of the Investment Company Institute[1]—mutual funds and other registered investment companies ("registered funds")—are the investment vehicles of choice for millions of Americans seeking to buy a home, pay for college, or plan for financial security in retirement. To help shareholders achieve their investment objectives, registered funds may use futures, options and swaps in a variety of ways. Like other participants in the derivatives markets, ICI members have a keen interest in ensuring effective and appropriate oversight of those markets by the Commodity Futures Trading Commission ("CFTC").

The CFTC's commissioners have expressed concern that the agency's funding is insufficient for it to "adequately fulfill the mission given to it by Congress: to prevent disruptions to market integrity, protect customer assets, monitor and reduce the build-up of systemic risk, and ensure to the greatest extent possible that the derivatives markets are free of fraud and manipulation."[2] Even with the 30% budget increase requested by President Obama, one of the CFTC's commissioners has expressed concern that the CFTC's proposed budget would be "insufficient [for the CFTC] to do the job."[3]

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. 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 $16.3 trillion and serve over 90 million shareholders.

[2] Testimony of Acting Chairman Mark P. Wetjen Before the U.S. House Appropriations Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies (March 6, 2014), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opawetjen-6.

[3] Statement of Commissioner Bart Chilton on the President's FY 2015 Budget (March 4, 2014), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement030414 (asserting that, even at such a funding level: (1) the CFTC's market coverage would not be as robust or comprehensive as is required; (2) the CFTC may be unable to bring as many enforcement cases; (3) inspection and management of clearing organizations would be "unacceptably risky;" and (4) the development of the compliance and exam programs in the CFTC Division that is responsible for overseeing, among others, commodity pool operators, would be drastically slowed; and (5) the CFTC would be unable to keep up with its data, reporting, registration and surveillance needs).

Given these concerns regarding the CFTC's limited resources, it is difficult to understand the agency's decision to modify Rule 4.5 under the Commodity Exchange Act ("CEA"), as part of a rulemaking that was not mandated (or even contemplated) by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Regulatory oversight of a significant number of new commodity pool operators ("CPOs") will further strain the CFTC's limited resources, as well as the resources of the National Futures Association ("NFA"), which serves as the frontline regulator for CPOs.

The Rule 4.5 amendments have required many registered fund advisers to register with the CFTC as CPOs, even though some of them do not offer funds that remotely resemble, or compete with, traditional commodity pools. In a related rulemaking to "harmonize" its requirements with those of the Securities and Exchange Commission, the CFTC largely adopted a "substituted compliance" regime, recognizing that registered funds were already comprehensively regulated—and their investors adequately protected by—the federal securities laws as administered by the Securities and Exchange Commission ("SEC").

ICI Views on the Rulemaking to Modify Rule 4.5

In February 2012, the CFTC voted to significantly narrow the exclusion from CPO regulation in Rule 4.5 under the CEA as it relates to registered funds and rescind an exemption from CPO registration that previously was available to sponsors of private investment funds. During the public comment period, ICI and many other stakeholders warned the agency that its proposals were overbroad, and offered a myriad of recommendations for tailoring the rules to achieve the CFTC's regulatory objectives without placing undue burdens on registered and private funds and their sponsors/advisers, as well as on the CFTC's limited resources. Unfortunately, the CFTC proceeded to adopt the rules largely as proposed. As anticipated by commenters, these rule changes have had significant implications for many asset management firms—*in addition* to the many new obligations imposed on these firms by the Dodd-Frank Act. Indeed, we understand that over 700 additional firms, which collectively operate thousands of registered and private funds, have now registered as CPOs.[4] Many more firms may be required to register in the future.[5] Unfortunately, most of the costs imposed by this additional regulation will be indirectly borne by fund shareholders.

The timing of these rule changes was unfortunate and unnecessary. The changes were not mandated by the Dodd-Frank Act, although the CFTC attempted to link them to the Act by describing them as being "consistent with the tenor" of that Act.[6] Their promulgation has required ICI members and other stakeholders to expend significant time and resources on

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[4] In addition, many firms have registered as commodity trading advisors as a result of the CFTC's rule changes.

[5] The CFTC staff has provided temporary registration relief for operators of "funds of funds," which the staff has defined very broadly. *See* CFTC No-Action Letter No. 12-38 (Nov. 29, 2012). More than 750 firms have relied on that relief to date, and many of those firms may have to register as CPOs in the absence of adequate future relief.

[6] *See, e.g.*, *Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations*, 77 Fed. Reg. 11252, 11253 (Feb. 24, 2012) (adopting release).

complying with the amended Rule 4.5 exclusion or, if they were unable to rely on the exclusion, registering as a CPO and complying with the applicable requirements.[7]

ICI, both individually and jointly with other trade associations, has submitted more than 20 requests to the CFTC and NFA for clarification, confirmation, and interpretive or no-action relief necessary to facilitate compliance as a result of the amended rule.[8] Many of these requests remain unaddressed, months after their submission. The registered fund industry is characterized by a strong culture of compliance, and the uncertainty created by these outstanding requests has made it unnecessarily challenging and costly for registered funds and their advisers to navigate their compliance obligations under CFTC regulations. These efforts have come at a time when ICI, its members and other stakeholders are devoting time and resources to understanding and complying with the many significant new rules that were required by the Dodd-Frank Act.

ICI's Primary Concerns with the Amendments to Rule 4.5

Rule 4.5 excludes certain "otherwise regulated entities" from CPO registration. From the rule's adoption in 1985 until passage of the 2012 amendments, all such entities—registered funds, insurance company separate accounts, bank trust and custodial accounts, and retirement plans subject to ERISA fiduciary rules—were accorded equal treatment. Now, registered funds alone must comply with certain trading and marketing conditions in order to rely on the Rule 4.5 exclusion. If a registered fund is unable to satisfy these conditions, its adviser must register as a CPO. In the two subsections below, we discuss our primary concerns with the CFTC's amendments to Rule 4.5.

1. **The CFTC failed to demonstrate the need for CPO registration by advisers to registered funds.**

Mutual funds and other types of registered funds are extensively regulated. They are the only financial institutions that are subject to all of the four major federal securities laws.[9] It bears emphasizing that the SEC regulates registered funds as investment vehicles, and not simply as participants in the securities markets; for this reason, SEC regulation of registered funds extends to their holdings in derivatives.[10] In addition, key CFTC rules already govern registered

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[7] The amendments impose upon virtually all advisers to registered funds the burden of continually monitoring their funds' portfolio composition, trading, and marketing activities to ensure that their registration status does not change.

[8] *Cf.* Testimony of Scott D. O'Malia, Commissioner, CFTC, Before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, Committee on Appropriations, U.S. House of Representatives, April 12, 2013 ("To date, the Commission has proposed approximately 65 rules and finalized more than 40 rules. It has also issued over 80 exemptions, staff no-action letters, Q&As, and guidance documents. This parallel track of ad-hoc and often last-minute exemptions has made the rules look like swiss cheese, leaving market participants uncertain as to the application of the Commission's rules.").

[9] The Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.

[10] Among other things, the SEC limits the ability of registered funds to create risk through leverage, including through use of derivatives; expects the registered fund's board to evaluate whether the fund's adviser has the capacity to measure and monitor the fund's risk exposure from use of derivatives; requires public disclosure that extends to investments in derivatives; and requires periodic disclosure of a registered fund's portfolio holdings, including all

funds when they trade in the commodity markets. These include, for example, the anti-manipulation provisions of the CEA,[11] the CFTC's "large trader" reporting rules,[12] as well as the swap data reporting rules required by the Dodd-Frank Act.[13]

In promulgating the amendments to Rule 4.5, the CFTC stated that it was targeting "de facto" commodity pools. Regrettably, the CFTC made no effort to determine whether its own oversight would complement, or merely duplicate, the SEC regime. Nor did the CFTC assess its *own* reporting requirements that already apply to registered funds that trade in the derivatives markets.

In August 2013, approximately eighteen months after adopting the Rule 4.5 amendments, the CFTC finalized its harmonization rule. In contrast to the original proposal, the final rule acknowledges the robustness of the SEC regulatory regime for registered funds by largely instituting a regime of "substituted compliance" —that is, registered fund advisers subject to the CFTC's jurisdiction are largely exempted from its compliance rules on the basis that adherence to the SEC's rules generally "should provide market participants and the public with meaningful disclosure … provide the [CFTC] with information necessary to its oversight … and ensure that [registered fund advisers] maintain appropriate records regarding their operations."[14]

2. The CFTC's cost-benefit analysis of the amendments was inadequate.

The CFTC conducted a very cursory analysis of the costs and benefits of its 2012 amendments to Rule 4.5. Moreover, it chose to conduct its rulemaking in a manner that made it impossible to meaningfully assess either costs or benefits. This is because the agency determined to impose the CPO registration requirement on registered fund advisers before fully examining the application of its "recordkeeping, reporting, and disclosure" provisions to such entities (this was done in the separate "harmonization" rulemaking mentioned above). By proceeding in this manner, the CFTC deprived itself, and the public, of the ability to know what costs and benefits would "flow from" the CPO registration requirement.

The agency's approach to cost-benefit analysis has been subject to criticism by Republican leaders of the House Agriculture Committee.[15] CFTC commissioners likewise have ex-

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open derivatives positions. *See, e.g.,* Section 18 of the Investment Company Act; *Disclosure and Compliance Matters for Investment Company Registrants That Invest in Commodity Interests,* IM Guidance Update No. 2013-05 (Aug. 2013), available at www.sec.gov/divisions/investment/guidance/im-guidance-2013-05.pdf; Rules 30b1-5 and 30e-1under the Investment Company Act; Item 27 of SEC Form N-1A (referencing Regulation S-X).

[11] *See* Sections 6(c) and 9(a)(2) of the CEA.

[12] 17 C.F.R. Parts 15-21 (market and large trader reporting rules).

[13] *See Swap Data Recordkeeping and Reporting Requirements*, 77 Fed. Reg. 2136 (Jan. 13, 2012); *Real Time Public Reporting of Swap Transaction Data*, 77 Fed. Reg. 1182 (Jan. 9, 2012).

[14] *See Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators*, 78 Fed. Reg. 52308, 52310 (Aug. 22, 2013).

[15] *See* Letter from Frank D. Lucas, Chairman, Committee on Agriculture, and K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk Management, to A. Roy Lavik, Inspector General, CFTC dated Mar. 11, 2011 ("the CFTC is failing to adequately conduct cost-benefit analysis – either as required by the [CEA] or the principles of the Executive Order [on Improving Regulation and Regulatory Review, issued by President Obama

pressed similar concerns about the manner in which the agency was conducting its cost-benefit analyses.[16]

Legal Challenge by ICI and the U.S. Chamber of Commerce

Given the seriousness of the concerns outlined above, in April 2012, ICI joined with the U.S. Chamber of Commerce to initiate a legal proceeding.[17] In December 2012, the U.S. District Court for the District of Columbia ruled in the CFTC's favor. On appeal, a three-judge panel of the United States Court of Appeals for the District of Columbia Circuit affirmed the district court ruling in favor of the CFTC. The Court noted that, as long as a reviewing court can "'reasonably . . . discern[]' the agency's path, we must uphold the regulation, even if the agency's decision has 'less than ideal clarity.'" The Court found that amended Rule 4.5 "clears this low bar." The Court also rejected appellants' argument regarding cost-benefit analysis, finding that the CFTC's explanations were adequate "to justify the marginal benefit of CFTC regulation of registered investment companies in the derivatives markets . . ."

Conclusion

The amendments to Rule 4.5 require the CFTC to devote significant time and resources to oversee certain registered funds and their advisers, an effort that duplicates oversight efforts of the SEC. This duplication is particularly acute given the CFTC's embrace of a "substituted compliance" regime for registered funds in its final harmonization rule. In our judgment, the CFTC has not demonstrated, nor could it demonstrate, that the great expansion of its regulatory activities through amended Rule 4.5 will produce any meaningful benefit to fund shareholders or protections for the markets. Instead, fund shareholders will largely bear the costs of this duplicative and unnecessary regulation. In evaluating the CFTC's request for additional resources, the Committee should encourage the CFTC to focus on its core regulatory obligations to protect the commodity markets and their participants, rather than devoting its scarce resources to overseeing entities that already are subject to comprehensive regulation.

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in January 2011] . . . . [p]articularly during tough economic times, it is incumbent upon the CFTC to approach cost-benefit thoroughly and responsibly to understand the costs, and therefore the economic impact any proposed regulation will have on regulated entities and markets.").

[16] *See, e.g.,* Letter from Scott O'Malia, Commissioner, CFTC, to the Honorable Jeffrey Zients, Acting Director, Office of Management and Budget, the White House, dated Feb. 23, 2012 (expressing "concern that the CFTC's cost-benefit analysis has failed to comply with the standards for regulatory review outlined in OMB Circular A-4, Executive Order 12866, and President Obama's Executive Orders 13563 and 13579."); Jill E. Sommers, Commissioner, CFTC, Opening Statement, Meeting on the Twelfth Series of Proposed Rulemakings under the Dodd-Frank Act (Feb. 24, 2011) (expressing similar concerns regarding numerous CFTC rulemakings, including the proposed amendments to Rule 4.5).

[17] *See* Complaint, *Investment Company Institute, et al. v. CFTC*, Case No. 1:12-cv-00612 (D.D.C. Apr. 17, 2012). ICI and the Chamber argued that, in finalizing the Rule 4.5 amendments, the CFTC failed to perform the most basic elements of a proper cost-benefit analysis, even though the CEA explicitly requires one; explain its reversal of its 2003 decision that CFTC regulation of registered funds was unnecessary, burdensome and would impair liquidity; and articulate any discernable benefits from the rule amendments above and beyond those already provided to investors through existing regulation. More information about the lawsuit and related issues is available on ICI's website at http://www.ici.org/cftc_challenge.