INVESTMENT COMPANY INSTITUTE

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STATEMENT OF THE INVESTMENT COMPANY INSTITUTE ON THE U.S. COMMODITY FUTURES TRADING COMMISSION'S APPROPRIATIONS FOR FISCAL YEAR 2016

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

March 13, 2015

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 President has requested a budget for the CFTC for fiscal year 2016 of $322 million, an increase of $72 million over the fiscal year 2015 enacted level.[2] CFTC Chairman Massad has explained that the CFTC's budget is "not at a level that is commensurate with the responsibilities Congress has assigned. . . ." and explained that "[t]he Commission's responsibilities were substantially increased by the Dodd-Frank Wall Street Reform and Consumer Protection Act ["Dodd-Frank Act"]. . . ."[3] Similar concerns about the CFTC's ability to meet its Congressionally-mandated responsibilities at its current funding levels have been raised by other CFTC commissioners as well.[4]

[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 $17.5 trillion and serve over 90 million shareholders.

[2] Testimony of Chairman Timothy G. Massad before the U.S. House Appropriations Committee, Subcommittee on Agriculture, Rural Development, Food and Drug Administration and Related Agencies (Feb. 11, 2015), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-10.

[3] *Id.*

[4] "The unfortunate reality is that, at current funding levels, the Commission is unable 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." Testimony of Acting Chairman Mark P. Wetjen before the U.S. House Appropriations Committee, Subcommittee on Ag-

Given these concerns regarding the CFTC's limited resources, it is difficult to understand the agency's decision in 2012 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 Act. 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. CFTC regulation of these registered fund advisers as commodity pool operators ("CPOs") further strains the CFTC's limited resources, as well as the resources of the National Futures Association ("NFA"), which serves as the frontline regulator for CPOs.

We therefore strongly supported Representative Garrett's amendment to H.R. 4413 ("Garrett amendment"), the Customer Protection and End User Relief Act, which passed the House in the last Congress on a bipartisan basis. The Garrett amendment would have exempted registered fund advisers from having to register with the CFTC as CPOs if their funds invest in commodity interests limited to "financial commodities," e.g., S&P 500 swaps and other securities-like derivatives, and do not invest in traditional commodities, such as natural resource and agricultural commodities.

Background on CFTC 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 stated 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.[5] Many more firms may be required to register in the future.[6] 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

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riculture, Rural Development, Food and Drug Administration and Related Agencies (March 6, 2014), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opawetjen-6.

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

[6] 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). Almost 900 firms have relied on that relief to date with respect to over 6,000 funds, and many of those firms may have to register as CPOs in the absence of adequate future relief.

describing them as being "consistent with the tenor" of that Act.[7] Their promulgation has required ICI members and other stakeholders to expend significant time and resources on 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.[8]

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.[9] Many of these requests remain unanswered, months or even years 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.

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.[10] It bears emphasizing that the Securities and Exchange Commission ("SEC") regulates registered funds as investment vehicles, and not simply as participants in the securities markets; for this

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

[8] The amendments impose upon virtually all registered fund advisers that are not currently required to register as CPOs the burden of continually monitoring their funds' portfolio composition, trading, and marketing activities to ensure that their registration status does not change.

[9] *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.").

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

reason, SEC regulation of registered funds extends to their holdings in derivatives.[11] In addition, key CFTC rules already govern registered funds when they trade in the commodity markets. These include, for example, the anti-manipulation provisions of the CEA,[12] the CFTC's "large trader" reporting rules,[13] as well as the swap data reporting rules required by the Dodd-Frank Act.[14]

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, conflict with, 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 a related rulemaking to "harmonize" its requirements with those of the SEC. 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."[15]

ICI's Support for the Garrett Amendment

The Garrett amendment would have addressed these concerns in a manner that is consistent with the CFTC's stated intent in adopting the Rule 4.5 amendments. The Garrett amendment would have continued to provide the CFTC with concurrent jurisdiction over advisers of those registered funds that resemble or compete with traditional commodity pools, such as a registered fund that offers a managed futures strategy or seeks exposure to the physical commodities

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[11] 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 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).

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

[13] 17 C.F.R. Parts 15-21 (market and large trader reporting rules).

[14] *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).

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

markets. At the same time, it would have restored to exclusive SEC jurisdiction advisers to those funds that invest in only financial derivatives (*e.g.,* an S&P 500 swap).

Furthermore, the Garrett amendment would have reduced the unnecessary regulation and costs created by the CFTC's rulemaking without undermining investor protection. All registered funds and their advisers would have remained comprehensively regulated by the SEC, including regulations that govern the funds' derivatives holdings. In addition, key CFTC rules would have continued to govern registered funds whenever they trade in commodity interests. Importantly, the Garrett amendment would not in any way have altered the CFTC's existing authority over all commodity interests, but only would have ended duplicative and unnecessary regulation of registered funds except those that invest in traditional commodities (*e.g.*, natural resource and agricultural commodities).

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. The Garrett amendment would have addressed these concerns by reducing the unnecessary regulation and costs created by the CFTC's rulemaking without undermining investor protection.