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Statement of the Investment Company Institute
Reauthorization of the Commodity Futures Trading Commission
Committee on Agriculture, Nutrition and Forestry

United States Senate

May 1, 2013

The Investment Company Institute (“ICI”)¹ appreciates this opportunity to provide input on the reauthorization of the Commodity Futures Trading Commission (“CFTC”). ICI’s members—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 CFTC.

As you recently noted, the Committee’s review comes at an important but challenging time for the agency, and a broad range of CFTC-related issues (*e.g.*, market oversight, agency oversight and resources, statutory authorities) should be examined in the context of the agency’s reauthorization.² In this letter, we outline our views on a number of issues relating to CFTC rulemaking to implement provisions in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. We also discuss the CFTC’s decision to modify Rule 4.5 under the Commodity Exchange Act 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 commodity pool operators (“CPOs”), despite the fact that both registered funds and their advisers were already subject to comprehensive regulation by the Securities and Exchange Commission.

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 \$14.96 trillion and serve more than 90 million shareholders.

² See “Dear Stakeholder” Letter dated March 5, 2013, available at <http://www.ag.senate.gov/newsroom/press/release/stabenow-cochran-cftc-reauthorization-letter>.

Rulemaking to Implement Title VII of the Dodd-Frank Act

Trade Execution

The Dodd-Frank Act amendments to the Commodity Exchange Act were intended to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things, imposing clearing and trading execution requirements on standardized derivatives products. The move from bilateral over-the-counter (“OTC”) transactions to execution of derivative instruments on exchange-like platforms and requiring a clearinghouse to clear those transactions, however, raise new concerns for buy-side market participants, including registered funds.

For example, for many swaps, mandatory trading execution will be required on designated contract markets (“DCMs”) or swap execution facilities (“SEFs”). As execution facilities, SEFs will be one of the avenues through which registered funds determine whether and how to interact in the swaps market. ICI is concerned, however, that the CFTC’s proposal that a request for quote (“RFQ”) be sent to five or more dealers may lead to information leakage and increase the potential for front running and the likelihood of the price of the swap moving against a fund. This higher price would be borne by registered funds and their shareholders in the form of a wider bid-ask spread. We agree with the concerns raised recently by a bipartisan group of members of Congress that “[a] minimum requirement would tie the hands of asset managers, preventing them from using their discretion, consistent with their fiduciary duties, to obtain the best price and execution for their clients. . . .”³

ICI believes that fund managers are best suited to determine the number of dealers to whom they send a request. Providing more flexibility to investors in the swaps market would benefit investors and, consistent with the intent of the Dodd-Frank Act, would encourage swap trading on SEFs, instead of reducing liquidity and pricing efficiency. We urge the CFTC to revise its SEF rule to reflect these concerns.

Customer Protection Concerns

Clearing and execution on DCMs and SEFs also will require the use of futures commissions merchants (“FCMs”) as intermediaries, and registered funds must deposit money, securities, and other property to margin cleared swaps in an account held by the FCM for the benefit of its customers. ICI strongly supports the CFTC’s proposal to provide greater protection for customers of FCMs and customer assets held by FCMs. In particular, we support a proposed requirement for FCMs to maintain an adequate targeted amount of excess assets in customer accounts, which would assist FCMs to maintain compliance with the segregation

³ See Letter from Reps. Scott Garrett (R-NJ), Gregory Meeks (D-NY), Robert Hurt (R-VA), and Gwen Moore (D-WI), Committee on Financial Services, U.S. House of Representatives, to the Honorable Gary Gensler, Chairman, CFTC, dated April 5, 2013.

requirements (*i.e.*, requirement to segregate from their own assets all money, securities, and other property deposited by customers). The CFTC's proposed requirement for FCMs to maintain an adequate target amount of excess assets in customer accounts and to comply with segregation requirements would help ensure that one customer's assets would not be used to satisfy another customer's margin obligations and would properly re-allocate costs from customers with excess margin to undermargined customers.

Moreover, in light of the two recent failures of FCMs, ICI and its members remain concerned that, in a case of an FCM insolvency, customers that did not contribute to a FCM's bankruptcy (through their own default) will suffer any shortfall in available customer assets, on a pro-rata basis. Even if customers establish a segregated arrangement for their swaps collateral, the assets maintained at a third-party custodian would, under the current Bankruptcy Code, be placed back into the estate of the insolvent FCM and subject to *pro rata* distribution. To provide FCM customers with greater protection, these provisions of the Bankruptcy Code should be amended to ensure that non-defaulting customers get back their money.

Block Trades

As derivatives migrate from bilateral transactions to executions on a regulated market as mandated by the Dodd-Frank Act, we believe the goal of market transparency must be balanced against adequately protecting information regarding a registered fund's large "block" trades. Block trades are transactions that enable registered funds, on behalf of their shareholders, to transact in large amounts with minimal disruption to the swaps market. Flexible and anonymous block trading is essential given the swaps market's comparative lack of depth and liquidity. In this regard, we have urged the CFTC (and the SEC) to adopt block thresholds that account for the liquidity in each unique category of swaps, recalculate the thresholds regularly, and establish thresholds that are low enough to encourage the use of block trades.

Global Concerns

As in the United States, jurisdictions around the world are enacting their own derivatives regulatory reforms to implement the G-20 commitments on OTC derivatives. In respecting international comity and practical considerations, ICI has urged the CFTC to regulate only those derivatives activities that have a "direct and significant" connection with the United States, as required by the Dodd-Frank Act, and we have specifically requested that the CFTC modify its proposed definition of U.S. person for collective investment vehicles to prevent an overly broad and unnecessary extension of its jurisdiction.

ICI also supports the effort by international regulators to coordinate their regulatory frameworks given that most derivatives transactions are conducted across jurisdictions. We have urged international regulators (including the CFTC) to achieve real and meaningful coordination regarding how cross-border transactions should be appropriately regulated to

avoid imposing conflicting or duplicative requirements. Without a clear agreement among regulators on a framework for how cross-border swaps transactions will be regulated by multiple jurisdictions, market participants, including registered funds, will face significant burdens in implementing a worldwide compliance system. We also believe that in developing an agreement on how market participants and transactions will be regulated, regulators must exercise restraint in creating a system that is too complex to implement in practice. A cumbersome and burdensome myriad of regulations on market participants that engage in derivative transactions around the world would be counterproductive and unnecessary.⁴

Rulemaking to Modify Rule 4.5

ICI Views on the Rulemaking Generally

In February 2012, the CFTC voted to rescind an exemption from CPO regulation that previously was available to sponsors of private investment funds, significantly narrow the exclusion from CPO regulation in Rule 4.5 under the Commodity Exchange Act as it relates to registered funds (discussed in more detail below), and impose new, extensive reporting requirements on all CPOs and commodity trading advisors registered with the CFTC.

During the public comment period and at a July 2011 roundtable discussion sponsored by CFTC staff, ICI and many other stakeholders warned the agency that its proposals were overbroad, and offered myriad recommendations for tailoring the rules to achieve the CFTC's regulatory objectives without placing undue burden on registered and private funds and their sponsors/advisers. 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 almost 600 additional firms, which collectively operate thousands of registered and private funds, have now registered as CPOs because of these rule changes and the expansion of the CPO definition to include swaps. Many more firms may be required to register in the near future.⁵

⁴ Similar sentiments were recently echoed by the Finance Ministers from eight countries and the European Commission. See Letter to Secretary Lew, Department of the U.S. Treasury, from Guido Mantega, Minister of Finance, Brazil; Pierre Moscovici, Minister of Finance, France; Taro Aso, Deputy Prime Minister and Minister of Finance, Japan; Pravin Gordhan, Minister of Finance, South Africa; George Osborne, Chancellor of the Exchequer, United Kingdom; Michel Barnier, Commissioner, European Commission; Wolfgang Schauble, Minister of Finance, Germany; Anton Siluanov, Minister of Finance, Russia; and Eveline Widmer-Schlumpf, Finance Minister, Switzerland, dated April 18, 2013 (“simultaneous application of multiple rules to cross-border activity will result in conflicting, inconsistent or duplicative requirements on market participants, which could be a real barrier to such trading”).

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 extension to date, and up to 625 of those firms may have to register as CPOs in the absence of adequate future relief. In addition, many firms have registered as commodity trading advisors as a result of the CFTC's rule changes.

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 describe 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 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. ICI, both individually and jointly with other trade associations, has submitted more than 15 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.⁷ These efforts 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.

Moreover, regulatory oversight of these new registrants will strain the CFTC’s limited resources, at a time when the agency acknowledges that it does not have the staffing or budget to meet new responsibilities under the Dodd-Frank Act.⁸ It likewise will strain the resources of the National Futures Association (NFA), which serves as the frontline regulator for CPOs.

ICI Views on 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,

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

⁷ 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.”).

⁸ See, e.g., Testimony of Gary Gensler, Chairman, 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 (advocating for a budget increase of approximately 52% while acknowledging that “the agency’s performance is affected by the challenges of limited resources” and that “[f]or the second year in a row, there are many goals that were not met”). See also Letter from Frank D. Lucas, Chairman, Committee on Agriculture, and K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk Management, to the Honorable Gary Gensler, Chairman, CFTC, dated July 14, 2011 (“In light of the volume of rules that are required by Title VII [of the Dodd-Frank Act], it is prudent to prioritize the time and resources of your staff. We recommend that you promulgate rules that are required before moving to rules that are not explicitly required by Dodd-Frank.” (going on to describe the proposed amendments to Rule 4.5)).

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 fails to satisfy these conditions, its adviser must register as a CPO. This imposes an additional layer of regulatory oversight by the CFTC and the NFA on registered funds, which already are subject to comprehensive regulation.

In the subsections below, we briefly describe our primary concerns with the CFTC's amendments to Rule 4.5. For these and other reasons, ICI and the U.S. Chamber of Commerce determined in April 2011 to challenge the Rule 4.5 amendments in court.⁹ We wish to emphasize that ICI did not decide upon that course of action lightly. In fact, we made every effort during the rulemaking process to advocate for a more sensible outcome: we filed three comment letters; met with CFTC commissioners and staff; participated in the CFTC staff's roundtable; and testified on Capitol Hill about these amendments. Many ICI members also filed comments. Unfortunately, the final amendments to Rule 4.5 did not achieve a sensible outcome, and given ICI's mission—to advance the interests of funds, their shareholders, directors, and advisers—we felt it was important to pursue this legal challenge.

1. CFTC failure 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. The Securities Act of 1933 and the Securities Exchange Act of 1934 regulate the public offering of their shares and ongoing reporting requirements, respectively. Registered funds must provide comprehensive disclosure to investors in plain English, including with regard to fees and expenses, the fund's investment objectives, and the risks of investing in the fund, including with respect to derivatives. The Investment Company Act of 1940 regulates a registered fund's structure and operations, and addresses fund capital structures (including limits on use of leverage), custody of assets, investment activities (particularly with respect to transactions with affiliates and other transactions involving potential conflicts of interest), and the composition and responsibilities of fund boards (whose independent members serve as "watchdogs" for the interests of fund shareholders).¹⁰ The investment adviser to a registered fund must register with the SEC and comply with the provisions of the Investment Advisers Act of 1940. Registered funds and their advisers are subject to antifraud standards. Finally, the federal securities laws provide the SEC with inspection authority over registered funds and their investment advisers, principal underwriters, distributing broker-dealers and transfer agents. The Financial Industry Regulatory Authority, Inc. (FINRA), a self-regulatory

⁹ See Complaint, *Investment Company Institute, et al. v. CFTC*, Case No. 1:12-cv-00612 (D.D.C. Apr. 17, 2012). More information about the lawsuit and related issues is available on ICI's website at http://www.ici.org/cftc_challenge. Notwithstanding the ongoing legal action, ICI is committed to assisting its members' efforts to comply with the amended rule.

¹⁰ See, e.g., *Burks v. Lasker*, 441 U.S. 471, 484-85 (1979) (noting that "the structure and purpose of the Investment Company Act indicate that Congress entrusted to the independent directors of [registered funds] . . . the primary responsibility for looking after the interests of the fund's shareholders.").

organization, also has oversight authority with regard to funds' principal underwriters and distributing broker-dealers.

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. Among other things, the SEC limits the ability of registered funds to create risk through leverage, including through use of derivatives; expects the fund board to evaluate whether the fund's adviser has the capacity to measure and monitor the fund's risk exposure from use of derivatives; and requires public disclosure that extends to investments in derivatives. Registered funds' use of derivatives is also subject to—among other things—prohibitions on affiliated transactions, requirements regarding portfolio concentration, and restrictions on counterparty credit exposure.

In addition, key CFTC rules already govern registered funds when they trade in the commodity markets. These include, for example, the CFTC's "large trader" reporting rules,¹¹ as well as the swap data reporting rules required by the Dodd-Frank Act.¹²

In promulgating the amendments to Rule 4.5, the CFTC stated that it was targeting "de facto" commodity pools. Regrettably, the CFTC provided no evidence that any registered fund was subject to inadequate regulation or posed any risk to the integrity of the commodity markets. The CFTC made no effort to determine whether its own oversight would complement, or merely duplicate, the SEC regime. Indeed, its discussion of the Section 4.5 amendments did not cite a single SEC regulation, assess the protections afforded by those regulations, or address how SEC regulation related to CFTC regulation of CPOs. Nor did the CFTC assess its *own* reporting requirements that already apply to registered funds that trade in the derivatives markets; without such an assessment, the agency could not possibly know whether there was some problem left unaddressed.

2. CFTC's inadequate cost-benefit analysis of the Rule 4.5 amendments

The CFTC conducted a very cursory analysis of the costs and benefits of its amendments to Rule 4.5, thus failing to satisfy the applicable requirements of the Commodity Exchange Act.¹³ Importantly, the agency failed to acknowledge in its analysis that any benefits that registered fund shareholders may receive as a result of these amendments would largely

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

¹² 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).

¹³ Section 15(a) of the Commodity Exchange Act requires the CFTC to consider the costs and benefits of its actions before issuing rules, regulations or orders. Section 15(a) requires the CFTC to evaluate the costs and benefits in light of the following five areas: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations.

duplicate many protections they already enjoy as a result of the Investment Company Act and other federal securities laws.

The CFTC's cost-benefit analysis was inadequate for another reason: the agency conducted 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 while suspending application of its "recordkeeping, reporting, and disclosure" provisions pending a separate rulemaking intended to "harmonize" those provisions with the SEC's regime. 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.

At the time the CFTC was conducting this rulemaking, the agency's approach to cost-benefit analysis was subject to criticism in other quarters. In March 2011, Republican leaders of the House Agriculture Committee requested that the CFTC's inspector general undertake an investigation of the adequacy of the Commission's cost-benefit analysis.¹⁴ Their letter observed that:

the CFTC is failing to adequately conduct cost-benefit analysis – either as required by the [Commodity Exchange Act] or the principles of the Executive Order [on Improving Regulation and Regulatory Review, issued by President Obama 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.

CFTC Commissioners likewise have expressed similar concerns about the manner in which the agency was conducting its cost-benefit analyses.¹⁵

Conclusion

The amendments to Rule 4.5 will require the CFTC to devote significant time and resources to oversee certain registered funds and their advisers, an effort that will duplicate

¹⁴ 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.

¹⁵ 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).

oversight efforts of the SEC. 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 investors or protections for the markets. We believe the CFTC instead should focus on completing its mandated responsibilities under the Dodd-Frank Act to protect the commodity markets and their investors.

We appreciate this opportunity to share our views. The issues discussed above have important implications for registered funds and the millions of Americans who use such funds to achieve their retirement and investment goals. They also impact the functioning of the derivatives markets and the effectiveness of the CFTC's regulatory program. We hope that the Committee will consider them as part of its work on the CFTC's reauthorization and in its general oversight of the agency.