INVESTMENT COMPANY INSTITUTE

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Investment Company Institute and U.S. Chamber of Commerce
v.
U.S. Commodity Futures Trading Commission
Case Summary

The Commodity Futures Trading Commission's (CFTC) recent changes to its Rule 4.5, which governs registration of commodity pool operators (CPO), are **unnecessary**—the CFTC has not demonstrated a need for additional regulation of registered investment companies—such as mutual funds and exchange traded funds (ETFs)—and their advisers; **redundant—**it imposes an additional layer of regulation on top of the Securities and Exchange Commission's (SEC) robust regulatory regime; and **costly—**ultimately funds and their investors will pay for these additional regulatory burdens in higher costs. CFTC Rule 4.5 currently exempts investment pools that trade in commodities from CFTC regulation if those pools are regulated elsewhere.

The Issue

- The CFTC's changes to Rule 4.5 will require many advisers to mutual funds and ETFs to register with the CFTC as commodity pool operators (CPOs)—imposing unnecessary, contradictory, and burdensome regulations on advisers and their funds and, ultimately, their shareholders.
- Commodities are an important tool many funds use to create diverse, lower-cost, lower-risk and more efficient portfolios. The new Rule 4.5 sets very low thresholds for the amount of commodity investments a fund can make before its adviser is required to register with the CFTC.
- Mutual funds and ETFs are already among the most highly regulated entities in the American financial system. By imposing CPO registration and CFTC regulatory requirements over the SEC's comprehensive regulation of these funds and their advisers, the CFTC's Rule 4.5 amendments will complicate funds' disclosures; interfere with communications with investors; and set back efforts to provide clearer, simpler, more usable disclosure to investors.

The Law

- ICI and the Chamber have filed their complaint in the U.S. District Court for the District of Columbia. The suit charges that Rule 4.5 is arbitrary and capricious, and that the CFTC violated the Administrative Procedure Act (APA) as well as the Commodity Exchange Act (CEA).
- In finalizing its rule, 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 mutual funds and ETFs was unnecessary, burdensome and would impair liquidity;

  - Articulate any discernable benefits from the rule above and beyond those already provided to investors through existing regulation;
  - Provide rational—much less adequate—justifications for the changes to Rule 4.5 as well as the added regulatory requirements and restrictions faced by funds that can no longer rely on the rule.

- These grounds are similar to successful challenges to agency regulations in other cases, including: *American Equity Life Insurance Company v. SEC* on the issue of failure to evaluate the effectiveness of the current regulatory regime; and *Business Roundtable v. SEC* and *Chamber of Commerce v. SEC* on the failure to properly consider the economic consequences of the rule.

The Implications

- Mutual funds and ETFs are already substantively regulated by the SEC and FINRA. In fact, they are the only financial products regulated under all four of the major federal securities laws.
- The removal of the Rule 4.5 exemption imposes unnecessary and sometimes contradictory regulation on highly-regulated mutual funds and ETFs. Ultimately, shareholders will pay the price for this extra layer of regulation in the form of higher costs, reduced market liquidity, confusion and less choice.
- Under the amendments to Rule 4.5, countless advisers overseeing funds would be hit by a vast array of red tape and regulatory burdens that largely duplicate the regulatory oversight already provided by the SEC and FINRA.
- The amended Rule 4.5 creates a host of problems including:
  - Duplicative and overlapping regulatory burdens thrust upon the most highly regulated financial products in America.
  - CFTC rules that contradict existing SEC requirements.
  - Increased costs and reduced choices for investors without any demonstrated benefits.
  - Added confusion for investors due to more complicated, redundant, and contradictory disclosure standards.
- Mutual funds and ETFs have been singled out for this additional regulatory burden, while other entities, such as banks, pension plans, and insurance companies would be allowed to engage in identical transactions with far fewer restrictions.
- In fact, in 2003 the CFTC amended the same rule—removing unnecessary registration and regulatory requirements—to encourage mutual funds and ETFs to invest in derivatives and bring additional liquidity to the commodity markets.
- The new rule is significantly more restrictive than any previous regulatory regime funds faced under Rule 4.5.
- The CFTC's changes to Rule 4.5 include funds' trading in swaps, even though the CFTC is currently engaged in a joint rulemaking with the SEC to define the term "swap." The CFTC's premature inclusion of swaps in the threshold for Rule 4.5 makes it impossible to fully predict the broad reach of the rule. But it is certain to be extensive and to ensnare hundreds of funds.

Next Steps

- The suit asks the court to prevent the CFTC from implementing the 2011 changes to Rule 4.5, leaving intact the 2003 standards.
- ICI and the Chamber intend to promptly request that the court grant them summary judgment and vacate the rule.