IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

INVESTMENT COMPANY INSTITUTE

and

CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA,

Plaintiffs,

v.

UNITED STATES COMMODITY FUTURES TRADING COMMISSION,

Defendant.

Case: 1:12-cv-00612 (BAH)

BRIEF FOR THE MUTUAL FUND DIRECTORS FORUM AS *AMICUS CURIAE* IN SUPPORT OF PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT

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GLOSSARY OF ABBREVIATIONS

CEA	Commodity Exchange Act
CFTC	Commodity Futures Trading Commission
CPO	Commodity Pool Operator
FINRA	Financial Industry Regulatory Authority
FSOC	Financial Stability Oversight Council
ICI	Investment Company Institute
NFA	National Futures Association
SEC	Securities and Exchange Commission
SIFMA	Securities Industry and Financial Markets Association

INTEREST OF *AMICUS CURIAE*[1]

Amicus Curiae the Mutual Fund Directors Forum (the "Directors Forum") is a nonprofit membership organization established as a resource for the independent directors of mutual funds. The Directors Forum provides training and educational programs for directors, recommends improvements and best practices in mutual fund governance, and advocates for reforms and policy positions that serve the interests of directors and the shareholders they represent. Membership in the Directors Forum is limited to the independent directors of U.S. registered investment companies.

Mutual funds, as registered investment companies, are governed by boards of directors that must include members who are independent of the fund's investment adviser. 15 U.S.C. § 80a-10(a); *see id.* § 80a-2(a)(19). The independent directors of a mutual fund are duty bound to guard the interests of the fund's shareholders. *See id.* § 80a-35 (fiduciary duty of directors); *id.* § 80a-10 (director interests must be "consistent with the protection of investors" to meet certain exemption requirements); *Burks v. Lasker*, 441 U.S. 471, 480-84 (1979). They bear a special responsibility to shareholders, without regard to the interests of the investment advisers. *See* Robert A. Robertson, Fund Governance: Legal Duties of Investment Company Directors 2-52 (2007). The Supreme Court has recognized that the statutory requirement that a mutual fund's board include independent directors is "[t]he cornerstone of the Investment Company Act's effort to control conflicts of interest within mutual funds," *Burks*, 441 U.S. at 482, and the Court has noted that the function of independent directors "without question" is "to supply an independent check on management and to provide a means for the representation of shareholder

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[1] No party's counsel has authored this brief in whole or in part, and no person other than *amicus* or its counsel funded the preparation of this brief.

interests in investment company affairs." *Id.* at 484 (internal quotation and alteration marks omitted). *See also Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1427-1428 (2010).

As fiduciaries and representatives of the shareholders who are the owners of a mutual fund, independent directors are particularly attentive to any significant change in regulatory requirements that will increase the costs to shareholders of operating the fund or reduce the fund's ability to implement the best investment strategies most efficiently, especially where the benefits of the regulatory change for shareholders may be insubstantial.

Consistent with its mission to promote the work of independent directors in their important role as representatives of mutual fund shareholders, the Directors Forum submits this brief to assist the Court in understanding how the rulemaking at issue in this case will impact the tens of millions of Americans who invest their savings in mutual funds. The decision of the Commodity Futures Trading Commission ("CFTC" or the "Commission") to reverse its longstanding position and to require a much broader range of mutual fund investment advisers to register separately as commodity pool operators ("CPOs"), even though all mutual funds are already pervasively regulated by the Securities and Exchange Commission ("SEC"), will impose significant new costs on mutual funds, and these costs will inevitably be passed along to shareholders. The new rule will also negatively impact the ability of mutual funds to implement the most efficient and beneficial investment strategies for shareholders.[2]

The Commission failed to quantify these regulatory costs or to consider their impact on investors. The Commission also failed to explain how these significant new burdens could be offset by any direct regulatory benefits for shareholders of mutual funds, since dual registration

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[2] The Directors Forum participated as a commenter in the Commission's rulemaking proceedings below. *See* Comments of the Mutual Fund Directors Forum (Apr. 12, 2011) ("Directors Forum Comments").

with the CFTC will not add any meaningful investor protections not already provided by the registration and disclosure requirements enforced by the SEC. For these reasons, the Directors Forum agrees with Plaintiffs that the Commission's decision to amend 17 CFR § 4.5 ("Rule 4.5") was arbitrary and capricious and failed to satisfy the cost-benefit analysis required by the Commodity Exchange Act ("CEA"), and the Directors Forum therefore urges the Court to grant Plaintiffs' Motion for Summary Judgment.

BACKGROUND

Nearly half of all American families invest in mutual funds, including more than 50 million households and more than 90 million individuals. *See* Investment Company Institute, *2012 Investment Company Fact Book: A Review of Trends in the U.S. Investment Company Industry* 87 (2012) ("2012 ICI Fact Book"). The shareholders of mutual funds range the gamut, from large institutions to individuals who purchase shares directly or who invest in mutual funds indirectly through employee benefit plans in order to save for retirement. *See* Clifford E. Kirsch and Bibb L. Strench, 1 Mutual Funds and Exchange Traded Funds Regulation § 1:1 (3d ed. 2011). Because of their diversified asset bases and managed risk portfolios, and because they generally offer lower transaction costs than individual stock and bond trading, mutual funds are the preferred choice of millions of Americans for the investment of their retirement savings and college savings accounts and for other long-term, stable investment strategies.

Mutual funds are among the safest and most trusted investments because they operate within a comprehensive regulatory framework tailored to their unique characteristics. All mutual funds are registered investment companies subject to comprehensive regulation by the SEC under the Investment Company Act of 1940, as amended. This regulation includes public registration and disclosure obligations, having a board of directors typically composed of a majority of independent members who are specially charged with safeguarding the interests of

shareholders, and other extensive regulatory requirements and protections administered and enforced by the SEC. *See* 15 U.S.C. §§ 80a-1 to 80a-64; 17 CFR pt. 270 (2012). The investment advisers to mutual funds are also subject to similar pervasive regulation by the SEC under the Investment Advisers Act of 1940, as amended. *See* 15 U.S.C. §§ 80b-1 to 80b-21; 17 CFR pt. 275 (2012). The underwriters and distributing broker-dealers for mutual funds are registered with the SEC under the Securities Exchange Act of 1934 (codified at 15 U.S.C. § 78a *et seq.*), and are further subject to the oversight of the securities industry self-regulatory organization, the Financial Industry Regulatory Authority, or "FINRA," *see* FINRA Rules, *available at* http://finra. complinet.com. Finally, just like all market participants, mutual funds are required to file disclosures with the CFTC when they engage in certain large trades in the commodity markets, *see* 17 CFR § 4.18 (2012), and are subject to other trading regulations, such as position limits, *see id.* pts. 150 and 151, as well as the antifraud provisions of the CEA, *see* 7 U.S.C. § 6b.

In 2003, the CFTC made a considered decision to exclude registered investment companies, including mutual funds, and their registered investment advisers from separate registration as commodity pool operators under the Commodity Exchange Act, precisely because they are already subject to comprehensive regulation under the SEC's broad registration and disclosure regime. *See* CFTC, Notice of Proposed Rulemaking, Additional Registration and Other Regulatory Relief for CPOs, 68 Fed. Reg. 12,622, 12,625 (Mar. 17, 2003). The Commission found that subjecting advisers of mutual funds to potential CPO registration had limited the trading activities of mutual funds, and thus the investment strategies available to investors, "to a much greater extent" than intended, *id.* at 12,625, because many fund advisers

had steered away from investments in commodity markets in order to avoid registration with both the CFTC and the SEC (referred to herein as "dual registration").

Thus, the Commission concluded in 2003 that shareholders of registered investment companies would benefit from a CPO exclusion by gaining "greater flexibility" and "efficiency" in their investment choices and "increased liquidity," and the Commission concluded that these benefits would come with "no decrease in the protection of market participants and the public" because registered investment companies are "otherwise regulated" by the SEC. 68 Fed. Reg. at 12,625; Notice of Final Rulemaking, 68 Fed. Reg. 47,221, 47,230 (Aug. 8, 2003).[3]

In the rulemaking at issue here, the Commission reversed course and substantially narrowed Rule 4.5's exclusion for registered investment companies. CFTC, Notice of Final Rulemaking, Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 77 Fed. Reg. 11,252 (Feb. 24, 2012). The new rule will require mutual fund investment advisers to register as commodity pool operators if the fund invests in commodity futures, options, or swaps with "aggregate initial margin and premiums" that exceed five percent of the liquidation value of the fund's portfolio, unless the adviser can demonstrate that these commodity investments are for "bona fide hedging" purposes only, as narrowly defined in 17 CFR §§ 1.3(z) and 151.5 (2012). *See* 77 Fed. Reg. at 11,283. The new rule also

[3] The CFTC adopted the first version of Rule 4.5 in 1985 to provide a narrow exception to CPO registration where the positions in commodity futures and options constituted "bona fide hedging" or long positions, were incidental to the entity's activities in the underlying cash market, and fell below 5% of the fair market value of the entity's assets. *See* CPOs, Exclusion for Certain Otherwise Regulated Persons, 50 Fed. Reg. 15,868 (Apr. 23, 1985). Over the years, the CFTC gradually expanded the exclusion to permit broader uses of commodity futures and options, while refining and narrowing the permitted forms of "bona fide hedging." *See, e.g.*, 58 Fed. Reg. 6,371 (Jan. 28, 1993). This evolution culminated in the 2003 rulemaking, in which the CFTC took the final step of removing all restrictions for registered investment companies and their advisers, which excluded mutual funds entirely from CPO registration obligations. *See* 68 Fed. Reg. 47,221 (Aug. 8, 2003).

includes an alternative exclusion if the "aggregate net notional value" of the fund's non-hedging commodity positions does not exceed 100 percent of the liquidation value of the fund's portfolio, after adjusting for any unrealized profits or losses on those positions. *See id.* Even if the fund's commodity investments do not exceed the thresholds, registration will still be required if the fund is promoted to the public as a vehicle for trading in the commodity markets. *Id.*

As a practical matter, the CFTC's new CPO registration regime for mutual fund advisers will actually be substantially broader than the registration requirements in place prior to 2003: It will be triggered not only by commodity futures or options trading (as under the pre-2003 rule), but also by trading in "swaps," an as-yet undefined term that potentially encompasses a broad new category of instruments not limited to commodity-based investments. *See* Compl. ¶¶ 3, 23(b), 28.

The Commission's primary motivation in adopting this 180-degree rule change was not to improve investor protections for shareholders of mutual funds, but rather to ensure that the agency would have its own separate stream of information about the management of registered investment companies that it could draw upon as a participant in the Financial Stability Oversight Council ("FSOC"), a multi-agency process established by the Dodd-Frank Act to help address systemic risks to the financial system. *See* 77 Fed. Reg. at 11,281:

> The Dodd-Frank Act charged the Commission, as a member of FSOC and as a financial regulatory agency, with mitigating risks that may impact the financial stability of the United States. The Commission is dedicated to assisting FSOC in that goal, and these final regulations are essential for the Commission to be able to fulfill that role effectively because the Commission cannot protect against risks of which it is not aware. By creating a reporting regime that makes the operations of commodity pools more transparent to the Commission, the Commission is better able to identify and address potential threats.[4]

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[4] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 111, 124 Stat. 1376, 1392-412 (2010) (creating the FSOC).

In its cursory discussion of the benefits of imposing a separate CPO registration requirement for mutual funds on top of the existing SEC registration regime, the Commission did not identify any direct investor-protection benefits to shareholders. Instead, it claimed that all "market participants" would benefit "at least indirectly, as a part of the United States financial system," from the Commission's own improved ability to participate in the FSOC process as a result of the informational advantage the agency will derive from dual registration. 77 Fed. Reg. at 11,281. *See id.* ("The total benefit of risk mitigation as it pertains to the overall financial stability of the United States is not quantifiable, but it is significant insofar as the Commission may be able to use this data to prevent further future shocks to the U.S. financial system."). It is unsurprising that the Commission did not claim the rule change would deliver any direct regulatory benefits to shareholders of mutual funds, since there was no evidence that existing SEC regulations are inadequate to protect the interests of investors in mutual funds, no suggestion that mutual funds contributed in any way to the financial crisis addressed by the Dodd-Frank Act, and no basis to believe that mutual fund trading in commodity markets poses a systemic risk to the financial system.[5]

At the same time, in approaching the cost-benefit analysis required by section 15(a) of the Commodity Exchange Act, 7 U.S.C. § 19(a), the Commission readily conceded that dual registration "will impose some significant costs on the [mutual fund] industry." 77 Fed. Reg. at 11,283. But the Commission did not quantify these costs, and it did not recognize and account

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[5] The Commission cited comments from the commodity industry's self-regulatory authority, the National Futures Association ("NFA"), asserting that three registered funds had been marketed to investors as "de facto commodity pools while claiming exclusion under § 4.5," 77 Fed. Reg. at 11,254, but the Commission never found that these or other funds posed a threat to the investing public. The Commission also claimed the new rule would help ensure that mutual fund advisers meet "minimum standards of fitness and competency," *id.* at 11,254, but the Commission never explained why the SEC registration and disclosure regime was insufficient in that regard.

for the fact that they will flow through to the shareholders of mutual funds and will therefore impose a new regulatory burden on the value of mutual fund investments. The Commission also neglected to discuss how the dual registration requirement is likely to reduce the variety of investment strategies that an adviser can efficiently offer to the fund's shareholders, and how this reduction in efficiency may negatively affect the shareholders' ability to mitigate inflation and volatility, manage investment risks, and preserve liquidity—the very concerns that led the Commission to adopt an unconditional exclusion from CPO registration in 2003.

SUMMARY OF ARGUMENT

In adopting the amendment to Rule 4.5, the CFTC failed to account for and justify the impact its rule change will have on the most important constituency in the mutual fund industry—the shareholders of mutual funds. By failing properly to analyze and weigh the costs and benefits of the rule change, particularly for shareholders, the Commission acted arbitrarily and capriciously and failed to satisfy the requirements of the Commodity Exchange Act.

First, the Commission failed adequately to account for the fact that the dual registration regime imposed by the rule change will significantly increase costs for mutual fund shareholders without producing any offsetting regulatory benefits. The costs of this new regulation will be borne by the tens of millions of Americans who rely on mutual fund investments for retirement, education, and emergency funds. Operating costs will rise for mutual funds that have previously been excluded from registration as CPOs, and these added operating costs will be passed on to shareholders directly in the form of higher mutual fund expenses. Costs incurred by registered investment advisers as a result of the new registration regime will also likely be passed on to shareholders indirectly, through higher management fees charged to the shareholders.

The regulatory burdens created by the new rule for shareholders will come with *no corresponding regulatory benefits* in terms of added investor protection. The Commission

completely failed to explain how the creation of a dual registration and disclosure regime would add any new investor protection to the existing pervasive regulation of mutual funds and their investment advisers by the SEC. The CFTC framed the expected benefits of the new rule almost entirely in terms of the agency's own institutional interest in gaining a new stream of information, and it only asserted in passing that all market participants generally will benefit "indirectly" from the enhanced "transparency" that dual registration will give the Commission. *See* 77 Fed. Reg. at 11,280-81. But the CFTC can readily obtain any needed information about the market activity of mutual funds from the SEC without the need for any costly new registration regime.

Second, the CFTC did not recognize that by requiring CPO registration for mutual fund advisers whose investments in commodity futures, options, or swaps exceed an arbitrary minimum threshold (most particularly, five percent of the liquidation value of the fund's portfolio), even where the fund is not marketed as a means to trade in commodity instruments, the new rule will inevitably lead to a reduction in the variety of investment strategies that can be efficiently offered by a mutual fund. This loss of efficiency and diversification will impose a real cost on shareholders by diminishing their ability to use the fund for managing risk and volatility and preserving liquidity in an uncertain economic climate.

The failure to consider and adequately analyze and account for these costs and the lack of offsetting benefits for shareholders of mutual funds renders the Commission's adoption of the challenged rule contrary to the express cost-benefit analysis provisions of the CEA, 7 U.S.C. § 19(a), and arbitrary, capricious, or otherwise not in accordance with the law in violation of the Administrative Procedure Act, 5 U.S.C. §§ 702, 706(2)(A), (C).

ARGUMENT

I. THE CFTC ACTED ARBITRARILY AND CONTRARY TO LAW BY ADOPTING THE NEW RULE WITHOUT ADEQUATELY CONSIDERING THE COSTS FOR SHAREHOLDERS OF MUTUAL FUNDS AND THE ABSENCE OF OFFSETTING REGULATORY BENEFITS

The Commission acted arbitrarily and contrary to the Commodity Exchange Act in amending Rule 4.5 because it failed to consider and quantify the costs the new rule will generate for shareholders, and it failed to recognize that dual registration will deliver no additional regulatory benefits for mutual fund investors. *See Bus. Roundtable v. SEC*, 647 F.3d 1144, 1154-56 (D.C. Cir. 2011).

Section 15(a) of the CEA, 7 U.S.C. § 19(a), requires the Commission to "evaluate" the "costs and benefits" generated by a proposed rule in light of five "considerations": (A) "protection of market participants and the public"; (B) "the efficiency, competitiveness, and financial integrity of futures markets"; (C) "price discovery"; (D) "sound risk management practices"; and (E) "other public interest considerations." *Id.* § 19(a)(1) & (2). Consistent with the established approach of courts and the executive branch, a sound cost-benefit analysis, as contemplated by section 15(a), requires the Commission to quantify, to the extent reasonably feasible, the material costs expected to result from compliance with the new regulation and to weigh those costs against the expected benefits to be obtained. *See Bus. Roundtable*, 647 F.3d at 1148-49.

Thus, an internal memorandum, issued by the CFTC's general counsel to guide the agency's rulemaking teams in analyzing costs and benefits under section 15(a), advises that "[c]osts and benefits should be quantified when it is reasonably feasible and appropriate to do so." Staff Memorandum from Dan M. Berkovitz, General Counsel, CFTC, to CFTC Rulemaking Teams (May 13, 2011) at 7, *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/

documents/file/oig_investigation_061311.pdf, Ex. 2 ("Berkovitz Mem."). This guidance directs the staff to follow the cost-benefit principles laid down for agencies in Executive Order 13,563, issued by the President on January 21, 2011, to the extent "consistent with section 15(a)," Berkovitz Mem. at 1, and it notes that Executive Order 13,563 requires agencies (consistently with section 15(a)) "to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible," and to "select the alternatives that maximize net benefits." Berkovitz Mem. at 2-3 n.5 (quoting Exec. Order No. 13,563, 76 Fed. Reg. 3,821 (Jan. 21, 2011)). Just two months after the Berkovitz memorandum instructed the Commission to follow Executive Order 13,563, the President signed Executive Order 13,579, which extended the earlier Order to independent regulatory agencies like the CFTC. *See* Exec. Order No. 13,579, 76 Fed. Reg. 41,587 (July 14, 2011).

The record here makes it clear that the Commission did not fulfill these requirements in adopting the new rule.

A. The CFTC Failed To Account for and Justify the Regulatory Costs that a Substantial Narrowing of the Rule 4.5 Exclusion Will Impose on Shareholders of Mutual Funds

The broad new CPO registration requirements created by the amendment to Rule 4.5 will impose a variety of significant costs on mutual funds and their advisers, and these costs will predictably flow through to the funds' shareholders. *See generally* Compl. ¶¶ 25, 33(c) (cataloging categories of costs imposed by the new Rule 4.5). The Commission itself itemized many of these same burdens when it decided in 2003 to exclude mutual funds and their registered advisers altogether from CPO registration. *See* 68 Fed. Reg. at 47,222. In the present rulemaking, however, the Commission neglected to give sufficient consideration to these costs.

The Commission acknowledged generally that the new rule will result in "significant costs" for the mutual fund industry, 77 Fed. Reg. at 11,283, but the Commission made no effort

to itemize or quantify these costs. This failure was contrary to section 15(a) and Executive Order 13,563, as interpreted and applied for the Commission by the general counsel's memorandum, and as extended to cover the CFTC and other independent regulatory agencies by Executive Order 13,579. Executive Order 13,563 itself provides examples of "values that are difficult or impossible to quantify" in rulemaking, and they include intangible factors like "equity, human dignity, fairness, and distributive impacts." 76 Fed. Reg. at 3,821. Most of the financial costs of compliance involved here, on the other hand, are concrete and not at all intangible.

As a basic matter of fund accounting, several of these costs will have to be treated as operating expenses of the fund and, as such, will be added directly to the expenses borne by shareholders.[6] These include the costs of: (a) making monthly reporting statements to shareholders, along with an annual report to shareholders and to the commodity industry's self-regulatory authority, the National Futures Association, 17 CFR § 4.22; (b) modifying existing disclosure documents, subject to the CFTC's Part 4 disclosure requirements, *id.* at §§ 4.21, 4.24-25; (c) filing additional disclosure documents with the NFA, 17 CFR § 4.26(d); and (d) becoming subject to substantively duplicative but operationally different record-keeping requirements, *id.* at § 4.23. The Final Rule also adds a new reporting obligation for many CPOs by amending 17 CFR § 4.27 and imposing a new quarterly reporting requirement. *See* 77 Fed. Reg. at 11,285-86. These direct operating costs will further include the necessary associated expenses of upgrading the fund's reporting and compliance systems and hiring the additional compliance personnel and counsel needed to monitor compliance with the CFTC's separate

[6] Such direct operating costs of a mutual fund are included in the fund's fee table as "Annual Fund Operating Expenses—Other Operating Expenses" and are periodically deducted from the shareholder's investment gains.

registration and disclosure regime. *See* Comments of the Investment Company Institute (Apr. 12, 2011) ("ICI Comments") at 11-12.

Other compliance costs may not appear in the fund's fees as direct operating expenses, but will nevertheless have a quantifiable financial impact on the fund's investment adviser. Such "adviser-level costs" will include (a) filing fees paid to the NFA, (b) fees paid for employees to prepare for and take certifying examinations required by the NFA, and (c) certain legal fees, such as legal fees incurred in determining whether a particular fund qualifies for an exclusion. Such adviser-level costs, too, will likely ultimately flow through indirectly to the shareholders of mutual funds, since these costs can be expected to result in higher management fees for new mutual funds and pressure to increase fees on existing funds to recoup the money lost adhering to the new dual reporting requirements. *See* SEC Staff, *Study on Investment Advisers and Broker-Dealers* (January 2011) at 162, *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf (concluding that certain costs that might be incurred by added regulation of investment advisers and broker-dealers would "ultimately [be] passed on to retail investors in the form of higher fees or lost access to services and products").

One principal reason why the Commission made no effort to quantify these compliance costs in adopting the amendment to Rule 4.5 is because their full extent is not yet knowable. The universe of registered companies subject to the new rule and the manner in which the rule and the thresholds triggering registration will apply to particular advisers will not be established until the Commission finalizes the definition of "swap," establishes margin requirements for swaps (however they are ultimately defined), and completes its rules purporting to achieve increased harmonization between CPO reporting requirements and corresponding SEC regulatory obligations. *See* 77 Fed. Reg. at 11,272, 11,277. This timing problem, however, results from the

Commission's own agenda for the staging of interrelated rulemakings; it cannot convert concrete costs into intangible costs, and it is not a justification that excuses the agency from satisfying the requirements of section 15(a).

Apart from its failure to quantify compliance costs, the Commission did not even acknowledge that these costs will be passed along to shareholders. That omission flies in the face of section 15(a) of the CEA, which expressly requires the Commission to evaluate the costs and benefits of a new rule in light of its impact on "market participants and the public," 7 U.S.C. § 19(a)(2)(A). It is also contrary to the general counsel's memorandum, which specified that the section 15(a) analysis must consider all costs that are "potentially significant to the public, the economy, the markets, and interested persons." Berkovitz Mem. at 6. There are no persons more "interested" in the costs generated by the Commission's rule change than the shareholders of registered investment companies, who will now bear the financial burden of dual registration in the form of higher mutual fund fees and expenses. These added costs will come out of the retirement funds, college savings, and rainy day savings accounts of tens of millions of Americans. *See* 2012 ICI Fact Book at 87 (reporting that 94% of mutual fund investors are saving for retirement, 48% are saving for emergencies, and 24% are saving for education).

The CFTC's total failure to quantify and consider these impacts on investors was arbitrary, capricious, and contrary to the requirements of section 15(a).

B. The CFTC Failed To Recognize that Requiring Dual Registration Will Confer No Regulatory Benefits on Investors in Mutual Funds

In adopting the amendment to Rule 4.5, furthermore, the Commission conducted no satisfactory evaluation establishing that the costs imposed on shareholders by the new dual registration requirement will be offset by any regulatory benefits. Indeed, the Commission refrained from even attempting to quantify any of the supposed benefits of its rule—which it

simply declared "unquantifiable." 77 Fed. Reg. at 11,277. *See id.* at 11,281 (stating that the supposed benefit of risk mitigation for the U.S. financial system is "not quantifiable"). In point of fact, there is nothing in the record to suggest that the dual registration burden will confer any regulatory benefits on shareholders at all.

The Commission asserted that CPO registration would serve the interests of investors by promoting "a minimum standard of fitness and competency" for registered entities (*i.e.*, fund advisers), and that prospective investors would "have the knowledge that such entities are held to a high financial standard through periodic account statements, disclosure of risk, audited financial statements, and other measures designed to provide transparency to investors." *Id.* at 11,280. Yet all of these claimed benefits are already realized for mutual fund investors by virtue of the SEC's comprehensive registration, disclosure, and enforcement regime administered under the Investment Company Act and the Investment Advisers Act. The Commission did not find, and had no basis to find, that SEC regulation of mutual funds was deficient or inadequately protective of shareholder interests.

Moreover, if anything, the CFTC's addition of a new layer of registration and disclosure obligations for mutual fund advisers on top of the existing SEC regime will only risk producing unnecessary confusion for investors from differing disclosures. As noted by commenters and highlighted in the Complaint, "additional disclosure" that provides "similar but non-identical information at different times, in different formats, and to different agencies w[ill] cause investor confusion." Compl. ¶ 33(b) (citing Comments of Janus Capital Management (Apr. 12, 2011) at 2). The SEC, over the course of decades, has developed detailed disclosure requirements for registered investment companies and advisers that ensure comprehensible and consistent

information for investors across different types of investment funds.[7] The new disclosure documents required by the CFTC, to the extent public, will be unfamiliar to mutual fund investors, will not conform precisely to the standards developed by the SEC (otherwise, the CFTC would simply rely on the SEC disclosures), and will likely have an adverse effect on investors' ability to compare the investment strategies of different mutual funds.

The absence of any meaningful investor protection benefits only underscores that the true purpose of the rule change was to advance the CFTC's own institutional interest in acquiring a source of market information for its use in the multi-agency FSOC process. See 77 Fed. Reg. at 11,252 ("The Commission is among those agencies that could be asked to provide information necessary for the FSOC to perform its statutorily mandated duties."). As commenters pointed out, however, this institutional interest of the Commission can be met through simple information sharing between the SEC and the CFTC. *See* Comments of Invesco (Apr. 12, 2011) at 5; Comments of Dechert LLP (Apr. 12, 2011) at 10. The Commission never explained why such information sharing would be unworkable.

Information disclosed to the SEC by registered investment advisers is easily shared by the SEC with the CFTC. All mutual fund disclosure and reporting to shareholders is publicly available on the SEC's online EDGAR system, and is also generally available on mutual fund Web sites. To the extent the CFTC believes it needs nonpublic information about commodity

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[7] *See, e.g.*, SEC, Division of Investor Management, *Study of Mutual Funds and Derivative Instruments* (Sept. 26, 1994), *available at* http://www.sec.gov/news /studies/deriv.txt (describing SEC actions taken to address investor protection issues raised by mutual funds' use of derivatives). The SEC continues to collect data on investors' preferences for disclosures and understanding of mutual fund communications. *See, e.g.*, Siegel & Gale LLC, *Investor Testing of Target Date Retirement Fund (TDF) Comprehension and Communications* (Feb. 15, 2012), *available at* http://www.sec.gov/comments/s7-12-10/s71210-58.pdf (study sponsored by the SEC to gather empirical data on "individual investors' understanding of target date retirement funds (TDFs) and advertisements related to those funds").

trading strategies from mutual fund advisers or information in a particular form that is different from the disclosures mandated by the SEC, nothing prevents the Commission from working with the SEC (perhaps through FSOC) to fulfill its information needs by relying on the SEC's regulatory authorities without introducing a costly dual registration regime.

And to the extent the Commission requires particular information about any significant commodity trading activity of mutual funds, it already receives such information through separate authority: For example, all market participants, regardless of registration status, that engage in large trades of commodity futures and options are required to make large trader reports to the CFTC on Form 40. *See* 17 CFR § 18.00 (2012). The Commission also maintains authority to issue special calls for information about particular trading accounts from commodity market participants. *See* 17 CFR pt. 21 (2012).

In the present rulemaking, the Commission never fully explained why these alternative sources of information cannot be developed to meet the FSOC purposes it wishes to advance.

II. THE CFTC NEGLECTED TO RECOGNIZE THAT CPO REGISTRATION WILL HARM INVESTORS BY REDUCING THE AVAILABILITY OF DIVERSIFIED RISK MANAGEMENT STRATEGIES OFFERED BY MUTUAL FUND ADVISERS

Mutual funds have adapted to the volatile economic environment in recent years by offering their shareholders efficient and prudent opportunities to invest in futures, options, and other derivatives as part of a well-diversified investment strategy to manage risk, to hedge against inflation and volatility, and to preserve liquidity. By imposing an arbitrary five-percent cap on the portion of a fund's holdings the adviser can invest in these instruments without triggering the costs and burdens of dual registration as a CPO, the new rule will reduce the ability of advisers to offer such strategies efficiently to the shareholders of existing mutual funds and will therefore inevitably lead to a reduction in the investment value of a fund for

shareholders. The Commission completely ignored this category of significant regulatory costs, even though the Commission's original decision to adopt the exclusion for registered investment companies in 2003 was justified by the need to avoid just such negative effects for investors.[8]

In times of economic uncertainty, investors seek diversified investment opportunities to nurture their retirement accounts and other personal savings. *See* Press Release, Investment Company Institute, *ICI Study: Mutual Fund Shareholders Remain Cautious but Steady Since the Financial Crisis* (Oct. 13, 2011), *available at* http://www.ici.org/pressroom/news/11_news_ownership (reporting that since 2008, the willingness of mutual fund investors to take "above-average or substantial investment risk" has declined). Investors have different tolerances for risk depending on their investment strategies and goals, 2012 ICI Fact Book, *supra*, at 29-30, and they often choose mutual funds specifically for their diversified portfolios. Investors may choose products that manage risk to their desired specifications within a particular fund, or they may choose to carry a portfolio of funds, each offering exposure to different types of investments, in order to achieve a desired balance. As the CFTC has noted, the benefits of diversifying stock and bond portfolios with physical commodity investments are well-recognized. Risk Management Exemption from Federal Speculative Position Limits, 72 Fed. Reg. 66,097, 66,098 (proposed Nov. 27, 2007) (to be codified at 17 CFR pt. 150).

Since the adoption of the Commission's unconditional exclusion for registered investment companies in 2003, mutual fund advisers have responded to these needs by

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[8] The CFTC's choice of the 5% trading threshold for CPO registration was arbitrary. It is not based on any analysis of the current trading practices of registered investment companies, but on a 25-year-old review of initial hedge margins and premiums in commodity transactions. *See* Comments of the Securities Industry and Financial Markets Association (Apr. 12, 2011) ("SIFMA Comments") at 8. The Commission itself seemed to recognize that the 5% threshold is too restrictive for today's investment strategies, since it acknowledged that "margin levels for securities product futures are significantly higher" than 5%, and "levels for swaps margining may be as well." 77 Fed. Reg. at 11,256.

developing a diverse assortment of efficient investment strategies, some including exposure to commodities instruments and other derivatives, that help investors find value within different risk-tolerance profiles. These investment strategies are not "speculation," but are designed for risk management. ICI Comments at 17. Like all mutual fund investments, the use of such strategies is subject to oversight by the independent directors of mutual funds. *See* Mutual Fund Directors Forum, *Risk Principles for Fund Directors* (April 2010), *available at* http://www.mfdf.org/director_resources/resource/risk_principles_for_fund_directors_april_2010/. The independent directors represented by *Amicus* the Directors Forum "have found that the use of derivative instruments by experienced investment advisers with appropriate infrastructure to manage the investments can serve the best interests of retail investors." Directors Forum Comments at 3.

Funds often use investments in "swaps, futures, and options as a means to efficiently manage their portfolios, rather than as part of operating a commodity fund." ICI Comments at 17. Commodities and related investments are used, for example, to manage cash and bond positions and to make adjustments in the duration of portfolios in the most cost-effective manner. *Id.* Investments by mutual funds in these instruments can also be used for other risk-management purposes, such as hedging against inflation and foreign exchange movements. SIFMA Comments at 11. Small investors may also seek access to the commodities markets in an efficient and affordable manner that limits their downside risk by purchasing funds that track commodity indexes. *Id.* These and other strategies can be used efficiently to balance risk across an investor's overall portfolio of investments.

The amendment to Rule 4.5 will fundamentally alter this landscape by imposing a financial penalty in the form of added registration costs when fund advisers offer shareholders

strategies that involve investments in commodity products and derivatives. The Commission specifically found just such a financial burden to be "too restrictive" when it adopted the 2003 exclusion. *See* Compl. ¶ 3; ICI Comments at 5. The new rule, however, will create an even greater financial burden on the ability of advisers to offer a variety of efficient strategies through a mutual fund than the burden that existed prior to the 2003 exclusion, since the new rule will count positions in swaps (yet to be defined) against the five-percent registration threshold, not just positions in commodity futures and options.[9]

The loss of efficient diversification strategies within mutual fund offerings resulting from the amendment to Rule 4.5 will directly harm the shareholders of those mutual funds by limiting effective opportunities to manage risks against volatility and inflation and to preserve liquidity. The CFTC made no mention of, let alone a meaningful effort to quantify, these lost opportunity costs for investors. This failure to recognize these harms to mutual fund investors is particularly unfortunate, since mutual funds were not a source of the systemic problems that led to the financial crisis of 2008. *See* 77 Fed. Reg. at 11,344 (Dissenting Statement of Commissioner Sommers).

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[9] The allowance in the rule for commodity investments that constitute "bona fide hedging" is too narrow to protect the risk management strategies described above. The definition of "bona fide hedging" in 17 CFR § 1.3(z) (2012) does not include "[t]he common understanding of 'hedging,' which generally encompasses a broad range of transactions that offset other specific risks, regardless of whether the hedger is a physical market participant or whether the risk hedged is commercial or financial." SIFMA Comments at 10. The "bona fide hedging" carved out of Rule 4.5 would not encompass, for example, the sorts of "asset/liability risk management" and "security portfolio risk management" commonly used by fund advisers for the benefit of investors. *Id.* (citation omitted).

CONCLUSION

For all of the foregoing reasons, the Mutual Fund Directors Forum urges the Court to grant Plaintiffs' Motion for Summary Judgment.

Respectfully submitted,

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