

MEMO# 25633

November 9, 2011

Mutual Funds a Focus at Senate Hearing on Excessive Speculation in the Commodity Markets

[25633]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 78-11

DERIVATIVES MARKETS ADVISORY COMMITTEE No. 47-11

SEC RULES MEMBERS No. 132-11

TAX MEMBERS No. 39-11 RE: MUTUAL FUNDS A FOCUS AT SENATE HEARING ON EXCESSIVE SPECULATION IN THE COMMODITY MARKETS

On November 3, the Senate Permanent Subcommittee on Investigations held a hearing entitled “Excessive Speculation and Compliance with the Dodd-Frank Act.” [\[1\]](#) In this and prior hearings, the Subcommittee’s Chairman, Senator Carl Levin (D-MI), has sought to show that trading in commodities by financial investors (so-called “speculators”) is causing price distortions in those markets, to the detriment of commodity users and producers that hedge their risks using futures contracts. Among the financial investors singled out at the hearing were mutual funds that, according to Senator Levin, are using “offshore shell companies” to circumvent the requirement that no more than 10 percent of a fund’s investment revenues should be realized from alternative investments, including commodities (referred to by Levin as the “10 percent rule”). [\[2\]](#) The hearing also focused on the position limits rule recently adopted by the Commodity Futures Trading Commission (“CFTC”) and whether that rule would be effective in curbing excessive speculation.

The Subcommittee first heard from a panel of witnesses that did not include any representatives from the financial industry, and then from CFTC Chairman Gary Gensler. A brief summary of the hearing (as related to mutual funds) is provided below.

Statements by Subcommittee Chairman and Ranking Member

Chairman Levin opened the hearing by emphasizing that the purpose of the commodity markets is to enable producers and users of physical commodities to arrive at market-driven prices and hedge their price risks over time, not to attract investors. In his view, the primary problem is “an explosion of speculators”—mutual funds together with commodity index funds, commodity exchange-traded products, and high frequency traders—that have

come to dominate commodity trading over the last decade. In so doing, these financial speculators have overridden “normal supply and demand factors,” with the result being distorted prices and increased price volatility. Levin congratulated the CFTC for establishing position limits on 28 key commodities, but expressed concern that the new rule is not designed to protect the American economy, consumers and businesses from “chaotic price swings that benefit speculators.”

In his opening statement, the Subcommittee’s Ranking Member, Senator Tom Coburn (R-OK), stressed that “the futures markets cannot function without speculators who make markets, provide liquidity for hedgers, aid in price discovery and take on risk.” In particular, he stated that “we need to be careful not to accuse investors of wrongdoing when none has occurred” and spoke of mutual funds and other investment vehicles as being “not diabolical schemes” but rather tools for investors to gain exposure to the commodity markets for purposes of hedging against inflation and other risks in their portfolios. Senator Coburn expressed concern that the CFTC rushed through its rule on position limits in the face of “intense political pressure” and opted for the “blunt weapon of across-the-board limits” rather than adopting limits at the proper level for each individual commodity.

Focus on Mutual Funds

Senator Levin’s opening statement cited to several exhibits that were entered into the hearing record. With regard to mutual funds, the exhibits included:

- A chart showing the increased number of (and assets invested in) commodity related mutual funds from 2008 to 2011 (see Attachment A to this memorandum)
- A list of 40 commodity related mutual funds, organized by “2011 net assets” (see Attachment B)
- Sample disclosures and marketing materials for several commodity related mutual funds
- The August 2010 rulemaking petition by the National Futures Association asking the CFTC to amend Rule 4.5 as applied to registered investment companies [\[3\]](#)
- A list of 72 private letter rulings (“PLRs”) from the Internal Revenue Service authorizing commodity investments by mutual funds, organized by PLR number

All three witnesses on the first panel [\[4\]](#) expressed views similar to those of Senator Levin, including that the new position limits are not stringent enough to curb excessive speculation in the commodity markets. When asked by Senator Levin, all three witnesses concurred that “mutual funds that trade in commodities [are] also contributing to commodity price speculation” and that the 10 percent rule should remain in place. As part of this discussion, Senator Levin alluded to the commodities provision that had been part of the RIC Modernization Act of 2010 and remarked that “we did actually stop [the commodities provision] in the Senate.” He went on to say:

And I think there’s been very little attention paid to this issue. And I would hope that one of the things this hearing would do would be to focus on this question, really for the first time, as to whether we ought to have this possibility, through the . . . shell corporations.

Chairman Gensler’s prepared testimony focused on the CFTC’s new position limits rule. In response to questions, Chairman Gensler did not attribute the CFTC’s adoption of the rule to a belief or finding by the agency that there is excessive speculation in the commodity markets. Instead, he pointed to the provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act relating to the establishment of position limits and said that such

limits can play a role in bolstering the CFTC's efforts to prevent manipulation in the commodity markets and ensure the price discovery function of those markets.

As regards mutual funds, Senator Levin asked about Chairman Gensler's understanding of the extent to which mutual funds are active in the commodity markets, either directly or "indirectly through offshore shell entities." In the ensuing dialogue, Chairman Gensler alluded to the CFTC's pending proposal to revise Rule 4.5 and indicated that he thought the proposal would be finalized "in the first quarter" of 2012. In the very last exchange of the hearing, Senator Levin returned to the subject of mutual funds and asked for Chairman Gensler's view on whether speculation in the commodity markets would increase if the 10 percent rule were eliminated. Chairman Gensler agreed to provide an answer to that question for the hearing record.

Post Hearing Press Coverage

A story in the Washington Post following the hearing characterized investments by mutual funds and other "passive investors" as contributing to a growing bubble in the commodities markets. The story and ICI's subsequent letter to the editor are included as Attachment C to this memorandum.

Rachel H. Graham
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[Attachment](#)

endnotes

[1] Opening statements, exhibits of the Subcommittee, and the written testimony of the witnesses are available at http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=86ccbdf3-645f-44f1-9bc7-7fe36693d8e8.

[2] Senator Levin is referring to section 851(b)(2) of the Internal Revenue Code, which requires that a fund seeking to qualify for Subchapter M tax treatment derive at least 90 percent of its gross income from specified sources (such as stocks, bonds, and currencies, and, importantly, other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in stocks, securities, or currencies).

[3] Rule 4.5 under the Commodity Exchange Act excludes certain "otherwise regulated entities," including registered investment companies ("funds"), from CFTC regulation applicable to commodity pool operators. In January, the CFTC proposed to narrow significantly the Rule 4.5 exclusion as applied to funds, by requiring compliance with certain trading and marketing restrictions. ICI detailed its strong objections to this proposal, and its recommendations for how the CFTC might appropriately revise the proposal to address its regulatory concerns, in a lengthy comment letter filed with the CFTC in mid-April. See Institute Memorandum [25107](#), dated April 14, 2011 (summarizing ICI's comment letter).

[4] The witnesses were: Paul N. Cicio, President, Industrial Energy Consumers of America; Tyson Slocum, Director of Energy Program, Public Citizen; and Wallace Turbeville, Derivatives Specialist, Better Markets, Inc.

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