

MEMO# 26050

April 17, 2012

ICI, U.S. Chamber File Lawsuit Challenging CFTC's Recent Amendments to Rule 4.5

[26050]

April 17, 2012

TO: BOARD OF GOVERNORS No. 4-12
CLOSED-END INVESTMENT COMPANY MEMBERS No. 20-12
COMPLIANCE MEMBERS No. 4-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 13-12
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 7-12
ETF ADVISORY COMMITTEE No. 7-12
EQUITY MARKETS ADVISORY COMMITTEE No. 5-12
FIXED-INCOME ADVISORY COMMITTEE No. 8-12
INVESTMENT ADVISER MEMBERS No. 4-12
SEC RULES MEMBERS No. 30-12
SMALL FUNDS MEMBERS No. 11-12
UNIT INVESTMENT TRUST MEMBERS No. 2-12
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 2-12 RE: ICI, U.S. CHAMBER
FILE LAWSUIT CHALLENGING CFTC'S RECENT AMENDMENTS TO RULE 4.5

ICI and the U.S. Chamber of Commerce (together, Plaintiffs) today filed a complaint in U.S. federal district court challenging the Commodity Futures Trading Commission's (CFTC) recent amendments to Rule 4.5 under the Commodity Exchange Act (CEA). [\[1\]](#) The amendments will significantly limit the ability of advisers to registered investment companies (funds) to rely on the rule's exclusion from CFTC regulation, and will likely require advisers to hundreds of funds that invest in commodity futures, commodity options, and swaps to register with the CFTC as commodity pool operators (CPOs). [\[2\]](#) The complaint charges that the CFTC's action was arbitrary and capricious, and violated applicable provisions of the CEA and the Administrative Procedure Act.

ICI believes a legal challenge to regulation is not a step to be taken lightly. The burdens that amended Rule 4.5 will place upon funds and their investors are of such significance, however, and the process by which these amendments were adopted fell so far short of the CFTC's legal obligations, that we felt we had no choice but to challenge this rule.

Set forth below is a high-level summary of the complaint, which is attached, and a

“roadmap” to the various topics addressed in the complaint. Plaintiffs intend promptly to request that the court grant summary judgment and vacate the rule.

Summary of Complaint

The complaint begins by stating that funds and their advisers “already are among the most highly regulated entities in the financial industry.” It explains that, in 2003, the CFTC excluded funds from regulation by that agency based on the fact that funds are “otherwise regulated” by the Securities and Exchange Commission (SEC). The complaint states that, prior to 2003, funds “generally had restricted their investment in commodity instruments due to the burdens associated with being subject to redundant and potentially conflicting regulation” by both the SEC and the CFTC. In determining to exclude funds from CFTC regulation, the CFTC explained that such exclusion would “encourage and facilitate participation in the commodity interest markets” by funds, and would therefore provide the “benefit to all market participants of increased liquidity.”

The complaint states that, in adopting the recent amendments to Rule 4.5, the CFTC “effectively reversed” its 2003 determinations, without “explain[ing] or determin[ing] in any manner that SEC regulation was proving to be insufficient, or that the benefits of increased liquidity no longer justified” funds’ exclusion from CFTC regulation. It further states that “in clear disregard for the most basic requirements of reasoned agency action, the [CFTC] simply ignored and declined to mention key elements of the reasoning it had previously followed in lowering the barriers to participation in the commodities markets that it was now raising again.” The complaint states that the recent amendments are “in fact significantly more restrictive than the regime the [CFTC] rejected in 2003” because Rule 4.5 would require, for the first time, registration of certain fund advisers on the basis of their trading in swaps or marketing the fund as a vehicle for trading in the swaps markets. Further, the complaint states that although the CFTC is statutorily required to consider the costs and benefits of the regulations it adopts, including their effects on efficiency and competition, “at critical junctions in its decision-making leading to adoption of the Rule, the [CFTC] failed to perform the most basic tasks of an appropriate cost-benefit analysis.”

Topics Addressed in the Complaint

- The comprehensive regulatory scheme to which funds and their advisers already are subject under the federal securities laws, as overseen by the SEC and the Financial Industry Regulatory Authority (Paragraphs 12-17);
- The reasoning behind the CFTC’s 2003 decision to exclude funds from regulation by the agency (Paragraphs 18-22);
- The CFTC’s decision to reverse, without explanation, its 2003 determination (Paragraphs 24-28);
- The shortcomings of the CFTC’s cost-benefit analysis with respect to the proposed amendments (Paragraphs 29-30) and the amendments as adopted (Paragraphs 48-49);
- The flaws with the CFTC’s rulemaking, as highlighted during the public comment process (Paragraphs 32-35);

- The shortcomings of the CFTC’s analysis in adopting the amendments (Paragraphs 39-52); and
- The six counts on which Plaintiffs request relief (Paragraphs 54-84).

Karrie McMillan
General Counsel

[Attachment](#)

endnotes

[1] Complaint, Investment Company Institute, et al. v. CFTC, Case No. 1:12-cv-00612 (D.D.C. Apr. 17, 2012), available at http://www.ici.org/pdf/12_commod_inv_complaint.pdf. The complaint also challenges the CFTC’s amendments to its Rule 4.27, which would impose new quarterly reporting obligations on commodity pool operators. More information relating to the lawsuit may be found on ICI’s website at http://www.ici.org/cftc_challenge.

[2] See Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 77 Fed. Reg. 11252 (February 24, 2012); correction notice published at 77 Fed. Reg. 17328 (March 26, 2012). For a more detailed discussion of the amendments, see ICI [Memorandum](#) , dated Feb. 10, 2012.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.