

United States Senate
WASHINGTON, DC 20510

November 30, 2011

VIA EMAIL (JRiley@CFTC.gov and DLeslie@CFTC.gov)

Mr. David A. Stawick
Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

RE: Proposed Amendments to Section 4.5: Reinstating Trading Criteria
for Exclusion from the CPO Definition (RIN number 3033-AD30)

Dear Mr. Stawick:

The purpose of this letter is to express support for amendments proposed by the U.S. Commodity Futures Trading Commission (CFTC) to its Section 4.5 to reinstate the “no marketing” and “five percent trading test” limitations for market participants seeking exclusion from registration requirements as commodity pool operators (“CPO”) under the Commodity Exchange Act.

Since these limitations were removed from Section 4.5 in 2003, mutual funds have established numerous funds dedicated to investing in the commodity futures, swaps, and options markets. Despite openly marketing themselves to the public as vehicles for trading in commodities, these mutual funds have not registered with the CFTC, the primary regulator of U.S. commodity markets, invoking instead Section 4.5’s broad exclusion of entities registered with the Securities and Exchange Commission (SEC). It is critical that the CFTC reinstate the Section 4.5 limitations and assert jurisdiction over these *de facto* CPOs so that the CFTC may properly safeguard investors and regulate the burgeoning growth of commodity related mutual funds. Once the Section 4.5 limits are reinstated and registration is required, the CFTC should also coordinate with the SEC to ensure that any conflicts arising from dual registration requirements are harmonized to clarify mutual funds’ obligations and minimize any burden.

Commodity Related Mutual Funds are Now Major Players

Currently, CFTC Section 4.5 excludes from CFTC registration requirements any entity that is registered with the SEC. Prior to 2003, to qualify for this exclusion, SEC-registered entities also had to represent in writing that they were not marketing themselves as commodity investment vehicles and were posting margins that represented less than 5% of their portfolios. In 2003, however, those two additional restrictions were removed from the regulation.

Since then, mutual funds have become major participants in the commodity futures, swaps, and options markets. In a recent hearing, the U.S. Senate Permanent Subcommittee on Investigations identified at least 40 commodity related mutual funds that over the last several years have accumulated assets in excess of \$50 billion.¹ Those figures represent a fivefold increase over 2008, when five commodity related mutual funds had assets totaling less than \$10 billion.² Each of these mutual funds has set up an offshore wholly-owned controlled foreign corporation (CFC) that exists solely to trade commodities in the futures, swaps, and options markets. The mutual funds typically organize their CFCs as Cayman Island subsidiaries; operate them as shell entities with no physical offices or employees of their own; and run the CFCs' commodity portfolios from their U.S. offices. That the Cayman CFCs are empty shells designed to allow U.S. mutual funds to create commodity related investment portfolios, run by their own U.S. employees, is openly acknowledged.

Although these funds are structured differently than public commodity pools and generally conduct their commodities trading through a subsidiary for tax purposes, they solicit retail investors to make investments in actively managed commodity related strategies. Their sales materials show they are marketing themselves to average investors as commodity funds and using their CFCs to delve into a wide array of commodity investments, from index swaps to exchange traded notes, to futures. In addition, many of these funds are offered directly to unsophisticated investors through online broker-dealers, often with a minimum investment of no more than \$1,000 to \$2,500. One mutual fund identified by the Subcommittee reported having over \$22 billion invested in commodity related assets with approximately 900,000 investors, 75% of which are individuals.³

The 40 mutual funds identified by the Subcommittee generally invest 25% of their total assets in their Cayman subsidiaries and often use U.S.-based assets as collateral or margin to secure the commodity investments being made by their CFCs in the futures and swap markets. In many instances, the mutual funds provide aggregate exposure to commodities as if 100% of the fund's net assets were invested in commodity related investments. Some mutual funds also offer investors leveraged exposure to their commodity related investments. Despite this activity, none of these funds is currently required to register with the CFTC as a commodity pool operator, due to the existing, broad regulatory exclusion for entities registered with the SEC.

CFTC Registration is Necessary to Protect Investors

The proposed amendments would reinstate the operating restrictions in place prior to 2003, that narrowed the registration exclusion to those SEC-registered entities that did not market themselves as commodity funds and traded less than 5% of the value of their portfolio in commodities.⁴ Reinstating those limits would ensure that the CFTC registration exclusion would

¹ "Excessive Speculation and Compliance with the Dodd-Frank Act" before the U.S. Senate Permanent Subcommittee on Investigations (November 3, 2011) (hereinafter Subcommittee Hearing), Exhibits 7a and 7b.

² *Id.* at Exhibit 1c.

³ *Id.* at Exhibit 7b, materials related to PIMCO Commodity Real Return Strategy Fund.

⁴ To qualify for the exclusion under the proposed amendments, an investment company such as a mutual fund registered under the Investment Company Act of 1940 would have to provide notice and represent that it: "(A) Will use commodity futures or commodity options contracts, or swaps solely for bona fide hedging purposes ... that the aggregate initial margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and unrealized

apply to only those SEC entities that participate in commodity markets on a *de minimis* basis. They would also ensure that mutual funds that devote a substantial portion of their investments to commodities and market themselves to the investing public as commodity funds are overseen by the federal agency with the greatest expertise and experience in regulating commodity products and markets and protecting commodity investors. The mutual fund industry's \$50 billion investment in commodity markets is continuing to grow and merits a cop on the beat with a focused interest in protecting commodity markets from wrongdoing.

The proposed amendments would ensure that commodity related mutual funds register with the CFTC and comply with CFTC solicitation and financial reporting and recordkeeping requirements. The resulting data would provide the CFTC with the means to effectively oversee these commodity market participants, prevent excessive speculation and price manipulation in commodity prices, manage the risks that such participants may pose to the markets, and protect their investors from fraud or other misconduct. The SEC does not have the equivalent expertise or experience in overseeing commodity related sales and trading practices. Requiring commodity related mutual funds to register with the CFTC would ensure a more efficient and effective system of oversight for these commodity related investment vehicles.

Requiring commodity related mutual funds to register with the CFTC would also increase investor protections. In October 2011, the CFTC disclosed that it had brought a record number of enforcement actions during the fiscal year, representing a 74% increase over the prior year. Many of these actions exposed and halted multi-million-dollar fraud and Ponzi schemes by CPOs. In one case, the CFTC successfully sought the return of nearly \$800 million to commodity pool investors who lost money in an alleged Ponzi scheme; in another matter concerning MF Global Holdings, a registered CPO, the CFTC is seeking the return of more than \$600 million in customer funds. Commodity related mutual funds, like all other types of commodity pools, need to be policed by an agency with expertise in commodities trading. Unless the current CPO exclusion is narrowed as proposed in the CFTC amendments, there is substantial risk that improper activities of mutual funds that are operating as *de facto* CPOs may go undetected.

To the extent that the dual SEC and CFTC registration requirements contain conflicting or duplicative disclosure obligations, the two agencies should undertake an effort to coordinate their respective requirements. For example, they should coordinate and harmonize the disclosure requirements relating to the delivery of prospectuses, fees, and past performance. The CFTC and SEC should do the same for reporting and recordkeeping requirements. Given the broad-based marketing efforts of many of the commodity related mutual funds to retail investors, resolving the differences in favor of greater disclosure would ensure greater transparency and greater investor protection.

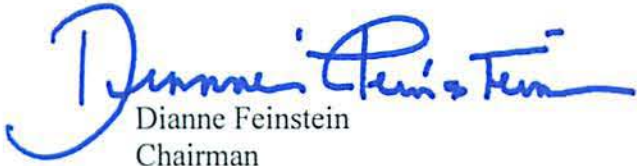
Until the proposed amendments are adopted and effective CFTC oversight is in place, investors will continue to be vulnerable to commodity related mutual funds that operate with

losses on any such contract it has entered into ...; (B)Will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in ... the commodity futures, commodity options, or swaps markets." 76 FR 1989 (February 11, 2011).

inadequate federal oversight. Accordingly, the Commission should act with urgency to re-establish the "no marketing" and "five percent trading test" limitations in CFTC Section 4.5.

Thank you for this opportunity to comment on the proposed amendments.

Sincerely,



Dianne Feinstein
Chairman
Subcommittee on Energy and Water Development
Appropriations



Carl Levin
Chairman
Permanent Subcommittee on Investigations