Commodity Futures Trading Commission
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Statement

STATEMENT BY COMMISSIONER O'MALIA

CHANGES TO IMPROVE CFTC OVERSIGHT OF RETAIL COMMODITY FUNDS

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The National Futures Association (NFA) recently proposed closing a regulatory gap that is increasingly undermining consumer protection laws and regulations applicable to the marketing and sale of commodity futures and options to retail investors. Specifically, the NFA has requested that the Commission close a 2003 loophole in Part 4 of its regulations that allows SEC-registered investment companies, e.g. mutual funds, specializing in commodity futures that solicit retail investors to operate as excluded entities, meaning that certain protections such as critical anti-fraud provisions of the Commodity Exchange Act (the "CEA") do not apply. I believe reasserting CFTC oversight over these retail futures funds is essential to consumer protection, especially as more Americans are seeking to diversify their investments by taking advantage of opportunities that allow them to leverage nominal initial investments to enter the futures and options markets. The Commission should expeditiously move forward and adopt the proposed changes to Regulation 4.5 as proposed by NFA.

Recently, several SEC-registered investment companies have started to offer mutual funds to retail customers that for the most part, if not solely, trade futures. These Futures Mutual Funds (FMFs) actively avoid CFTC regulation by claiming an exclusion from Commodity Pool Operator ("CPO") registration under CFTC Regulation 4.5(a)(1). Until the recent influx of new mutual funds specializing in futures trading, the use of the exclusion, in effect a form of regulatory arbitrage, was innocuous. However, continuing to allow FMFs to operate by evading CFTC oversight and its substantial disclosure obligations now poses increased risks to the market and to retail investors.

Since these investment products are specifically marketed to the public as commodity futures and options products, additional transparency regarding risks and fee exposure is warranted, as is the full application of all consumer related anti-fraud regulations. It is time that the Commission retake the authority conceded in 2003 and close the loophole.

Regulation 4.5 currently offers an exclusion to a fund if it is registered with the SEC under the Investment Company Act of 1940 (the "1940 Act"). The premise behind the exclusion in Regulation 4.5 is two-fold: (1) the qualifying fund would otherwise be, in effect, dually regulated and (2) the fund makes use of limited futures and commodity options trading. The intention of the exclusion in 2003 was to streamline regulation of businesses already subject to extensive federal and state supervision – not to permit regulatory evasion.

These new FMFs have designed a clever end-run around the letter of the 1940 Act by establishing subsidiaries to invest in commodity futures which conveniently are not subject to CFTC jurisdiction or directly subject to the 1940 Act. While the FMFs' intent may be to use these subsidiaries to avoid a requirement under Sub-chapter M of the Internal Revenue Code that requires 90% of a funds income to come from securities investments, favorable tax treatment does not justify the increased risk placed on consumers.

In order to restore the highest standard of consumer protection and disclosure, the Regulation 4.5 loophole for SEC regulated Futures Mutual Funds should be closed. The CFTC should require that only entities subject to the Part 4 regulations should be allowed to solicit retail customers. Without CFTC and NFA oversight, FMFs and other such funds that mimic CPOs, but do not abide by the same structure, will continue to avoid specific disclosures mandated for CPOs in the interest of consumer protection including: disclosures over fund risk exposure; performance returns; fee structures; and advisor conflict of interest information. Moreover, without intervention, the marketing of FMFs and the like will continue to evade application of the specific antifraud provisions of the Commodity Exchange Act under Section 4(o) applicable to CPOs, among others.

The CFTC's mission is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options. As a means to meet that mandate, the CFTC is always looking to ensure the greatest practicable degree of transparency and disclosure. As it stands now, there are 21 CFTC-registered CPOs offering 55 public-oriented pools that meet current regulatory standards. The Regulation 4.5 exclusion currently creates an arbitrage opportunity for these CPOs to register under the 1940 Act as FMFs, freeing them from the oft burdensome consumer protection regulations of the CFTC. Continuing to allow the possibility of a mass migration to (not to mention a new population in) murky, unregulated territory runs counter to the mission of the CFTC and goals of the Commodity Exchange Act.

The Commission must insist on full and robust consumer protections as more and more investors are looking to commodity markets for investment exposure and diversification. The CFTC should act now to close this loophole on FMFs before they have a chance to inflict real harm on retail investors.