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 No. 1:12-cv-00612 (BAH)

BRIEF FOR NATIONAL FUTURES ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF DEFENDANT COMMODITY FUTURES TRADING COMMISSION'S CROSS-MOTION FOR SUMMARY JUDGMENT, OPPOSITION TO PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT, AND MOTION TO DISMISS IN PART

Dated: June 25, 2012

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I. INTRODUCTION AND STATEMENT OF INTEREST OF *AMICUS CURIAE*

Amicus Curiae National Futures Association ("NFA") is the independent, self-regulatory organization for the United States futures industry whose fundamental mission is to protect the integrity of the U.S. futures market. The NFA seeks to participate in this case as *amicus curiae* to advise the Court of the vital public interest that is served by the Commodity Futures Trading Commission's ("CFTC" or "Commission") recent amendments to CFTC Rules 4.5 and 4.27 (the "Final Rule") and to explain the harm that retail investors would be exposed to if these amendments were invalidated.

Among the many lessons learned from the turmoil in the financial markets and the related global economic crisis of the past five years is the importance of requiring that the investing public has full disclosure of the risks and costs associated with different types of investments. There is a particularly compelling interest in disclosing levels of risk when it comes to investment companies' use of derivatives which, by their very nature, are highly risky due to their use of leverage. The CFTC's Final Rule will restore the reach of the CFTC's regulatory oversight to again include investment companies that use derivatives beyond a *de minimis* amount and/or are marketed as a commodity pool or otherwise as a vehicle for trading in commodity interests. Among other benefits, this will ensure that these companies specifically disclose the risks associated with their use of derivatives, positions they take in derivative markets, past performance information regarding other similar funds, and all fees and costs by way of a break-even analysis. In other words, the Final Rule will protect retail investors by ensuring that investment companies provide them with the information they need to evaluate the risks and costs of specific investments in derivatives.

It is entirely implausible to challenge the rationality of these customer protection disclosure requirements or the CFTC's authority to impose them. Knowing that, plaintiffs contend instead that the Final Rule is unnecessary, and thus arbitrary and capricious, because the transactions at issue are already regulated by the Securities and Exchange Commission ("SEC")

under the Investment Company Act of 1940 ("Investment Company Act"), 15 U.S.C. § 80a-1 et seq. But plaintiffs have it wrong, as the CFTC's Final Rule targets a broad array of transactions that are not covered by the Investment Company Act. By amending Regulation 4.5 to re-impose operating restrictions in place prior to 2003, the CFTC has eliminated a perilous regulatory gap it created nearly a decade ago, which has resulted in insufficient oversight and disclosures for investors in certain investment companies. The Final Rule is thus supported by a compelling public interest and easily satisfies the deferential arbitrary and capricious standard that applies to agency rulemaking.

As a "futures association" registered with the CFTC under the Commodity Exchange Act (the "CEA"), 7 U.S.C. § 21 (2006),[1] NFA is uniquely positioned to describe the public interests at stake in this case and the need for the regulations the CFTC has enacted. NFA's membership includes more than 3,550 firms registered with the CFTC and approximately 51,000 individuals who conduct business with the public on U.S. futures exchanges. Membership in NFA is mandatory for most firms and individuals registered with the CFTC. NFA engages in multiple activities to protect the integrity of the U.S. futures markets, including developing and enforcing rules that apply to NFA members who participate in derivatives markets through commodity pools. More than 1,050 of NFA's members are "commodity pool operators," as that term is defined in the CEA. Accordingly, NFA has a keen interest in the CFTC's Final Rule.

In submitting this *amicus* brief, NFA emphasizes the importance of providing the investing public with broad access to the derivatives markets. For the protection of retail investors, in particular, and the effective functioning of the derivatives markets, however, it is essential that the regulatory scheme that applies to derivatives allows investors to make investment decisions with full knowledge of the financial risks and costs they are assuming. The CFTC's Final Rule achieves that purpose and should be upheld.

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

II. BACKGROUND

In the section that follows, NFA describes the relevant statutory and rulemaking scheme relating to derivatives for the purpose of demonstrating that, contrary to plaintiffs' contention, the requirements imposed by the Final Rule fill a regulatory void and are not duplicative of requirements imposed by the pre-existing regulatory scheme for investment companies.

A. The CFTC's Authority to Regulate Derivatives

The starting point for evaluating the lawfulness of the Final Rule is the CFTC's authority under the CEA to regulate derivative transactions involving commodities. The broad purpose of the CEA is "to serve the public interests . . . through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the [CFTC]." 7 U.S.C. § 5(b). The CEA grants the CFTC exclusive regulatory authority over derivative transactions involving swaps, contracts of sale of a commodity for future delivery, or options on a commodity. *See* 7 U.S.C. § 2(a)(1).

As used in this context, a "derivative" is a leveraged financial instrument for which the return on the investment depends upon the investment performance of some other asset (i.e., a reference asset). Investors often use derivatives to hedge against a risk that is already present in an investment portfolio. They are also used for speculative purposes, exposing the investor to risk in the hope of obtaining a greater return.

The inherently risky, leveraged nature of derivatives explains the strong public interest in closely regulating them. Because the performance of a derivative is tied to the performance of some other asset, the widespread use of derivatives increases the risk of losses throughout a market. For example, if the value of a particular commodity decreases, the resulting losses are borne not only by the owners of and investors in the actual underlying commodity, but also by investors in derivative instruments that reference that commodity. This risk of systemic loss is exponentially increased by another defining feature of derivatives: they always involve some

degree of leverage, which allows investors to take large price positions in a market for a relatively small commitment of capital.[2]

As part of its statutory design for regulating derivatives, Congress gave the CFTC jurisdiction over various participants in the derivatives markets, including "commodity pool operators." The CEA defines a commodity pool operator as "any" person or entity operating a business in which they solicit or accept value "for the purpose of trading in commodity interests, including any" commodity future, option, or swap. 7 U.S.C. § 1a(11)(A). There is no minimum amount of trading that triggers this definition; nor is there a statutory exclusion from this definition for persons or entities that also trade in the securities markets, which are regulated by the SEC. Thus, of particular importance in view of plaintiffs' claim that the CFTC is engaged in duplicative regulation, an entity that trades a single commodity futures contract falls within the definition of a commodity pool operator and is subject to regulation by the CFTC, *even if that entity is also regulated by the SEC*.

The CFTC's congressional grant to regulate commodity pool operators includes the authority to exclude some operators from regulation and from the requirement to register with the CFTC. 7 U.S.C. § 1a(11)(B). The history of the CFTC's exercise of this "exclusion" authority bears directly on the evolution of the Final Rule and thus merits the discussion in the section that follows.

B. The CFTC's Past Exclusion of Certain Registered Investment Companies From Regulation Under the Commodity Exchange Act

In 1985, the CFTC adopted Rule 4.5 which, in its original incarnation, excluded registered investment companies that used derivatives for hedging only and met the following criteria: (1) all of the investment company's commodity interest transactions were bona fide hedges or other anticipatory hedges; (2) the investment company did not use more than 5% of its

[2] Leverage is described as "external" when a derivative contract is purchased or sold using margin that is a fraction of the contract's notional value, with the potential for a return that is much greater than the actual dollars at risk. A derivative has "internal" leverage where, for example, the instrument pays an interest rate that is designed to perform the opposite of the prevailing trends in the market.

assets as initial margin in relation to derivatives trading (the "*de minimis* trading restriction"); and (3) the investment company was not marketed as a commodity pool or other vehicle for trading in commodity interests (the "no-marketing restriction"). 50 Fed. Reg. 15,868 (Apr. 23, 1985). If a registered investment company met these operating restrictions to qualify for the exclusion, it was not required to register with the CFTC as a commodity pool operator.

This regulatory framework remained in place for almost a decade, until 1993, when the Commission amended Rule 4.5 to slightly broaden the *de minimis* trading restriction by removing the condition that the derivatives trading had to be for hedging activity only. Following that amendment, a registered investment company could engage in an unlimited amount of bona fide hedging activity – and other risk management and speculative strategies – and still qualify for the exclusion, as long as no more than 5% of its assets were used as initial margin. 58 Fed. Reg. 6371 (Jan. 28, 1993). This broader *de minimus* trading restriction and the no-marketing restriction remained in place for another decade until 2003, when they were eliminated during the financial deregulation movement. *See* 68 Fed. Reg. 47221, 47223 (Aug. 8, 2003); *see also* CFTC Mot. 10 (ECF No. 15).

The CFTC's decision in 2003 to eliminate these restrictions – and thereby exclude essentially all registered investment companies from the definition of commodity pool operator – was the product of a very different investment and financial regulatory environment than exists today. When it issued the 2003 rule, the CFTC explained that eliminating its regulatory oversight of these investment advisers was appropriate given the "investment environment" at the time and would "have no effect . . . on the financial integrity . . . of the commodity futures and options markets." 68 Fed. Reg. 47221, 47,223, 47,230 (Aug. 8, 2003). The CFTC also explained then that, since registered investment companies are "'otherwise regulated,' the Commission believes that . . . these persons and entities may not need to be subject to any commodity interest trading criteria to qualify for relief under Rule 4.5." 68 Fed. Reg. 12622, 12625-26 (Mar. 17, 2003).

Thus, based on investment conditions in 2003 and the determination that registered investment companies were already "otherwise regulated," registered investment companies have enjoyed nearly a decade of categorical exclusion from CFTC regulation as commodity pool operators, regardless of the volume or the purpose of their derivative trading, or how they marketed the units they issued.

C. Responses by Congress and the CFTC to the Financial Crisis: The Dodd-Frank Act and the CFTC's Elimination of the Regulatory Exclusion for Registered Investment Companies

Times have changed since 2003, ever so drastically. The unprecedented crisis in the financial markets that occurred in 2007-08 ushered in a new era. With the painful regulatory lessons of that crisis, Congress became deeply concerned about systemic market risks posed by extensive unregulated investments in derivatives. In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which amended the commodity pool operator definition, provided for a separate definition of commodity pool, and expressly extended the CFTC's jurisdiction over "swaps." Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 7 U.S.C. §§ 1a(1) & 1a(11)).

Just a month after the Dodd-Frank Act was signed into law, NFA took action of its own by filing a petition for rulemaking in which it requested that the CFTC (1) reinstate Rule 4.5's *de minimis* trading and no-marketing operating restrictions, and (2) make registered investment companies that cannot meet these requirements ineligible for the exclusion in Rule 4.5.[3] The CFTC issued a Notice of the NFA Petition on September 17, 2010. 75 Fed. Reg. 56997 (Sept. 17, 2010).

The concerns discussed in NFA's petition – and recognized by the CFTC's Notice of the petition – provide an important backdrop for the CFTC's Final Rule. As NFA described in the

[3] The NFA petition is among the documents publicly available at http://www.cftc.gov/LawRegulation/RulemakingRecords/CPOCTARecords/index.htm, which the CFTC will be lodging with the Court as the Administrative Record in this case. *See* Consent Mot. 2 n.1 (ECF No. 14); June 19, 2012 Minute Order (denying motion for leave to file index of documents available at this website in lieu of Administrative Record and directing CFTC to file these documents with the Court).

petition, instead of directly and openly investing in commodity futures transactions, several registered investment companies have been using wholly-owned and controlled subsidiaries to make those investments on their behalf.[4] NFA Pet. 3-4, 6-9. While the offering materials for these investment companies indicate that the subsidiaries are subject to certain investment restrictions applicable to the investment companies themselves, the reality is that the derivatives trading activities of these subsidiaries are not regulated by the CFTC or NFA. Of equal concern, these subsidiaries are also not subject to the Investment Company Act's investor protection regime. *See id*. In practical terms, the lack of regulatory oversight means there is no reliable means for determining, for example, the actual derivatives positions taken by these subsidiaries and the degree to which those positions are leveraged.

To put it starkly, certain registered investment companies took full advantage of the CFTC's 2003 amendments to Regulation 4.5 and began to extensively – and in some cases exclusively – use derivatives in their investment strategies, and directly market these investment companies to retail investors as commodity investments with minimum investments as low as $2,500. These registered investment companies are *de facto* commodity pools that fall entirely outside the CFTC's and NFA's customer protection regulatory regime for commodity pool operators. *See id*. These investment companies are offering their units to investors without any regulatory requirement that their investment advisers disclose the past performance of similar funds. Moreover, their use of wholly-owned subsidiaries creates a structure in which the nature and amount of the fees that are passed on to the parent registered investment company and its investors is wholly opaque in most instances.[5] This lack of disclosure, transparency, and

[4] The use of a subsidiary is intended to provide the registered investment companies with exposure to futures and commodities in a manner consistent with the limitations of the federal tax requirements in Subchapter M of the IRS Code. Subchapter M requires, in part, that at least 90% of a regulated investment company's income be derived from securities or derived with respect to its business of investment in securities (*i.e.*, qualifying income). The registered investment companies rely upon IRS private letter rulings to other investment companies, which indicate income from a registered investment company's investment in a subsidiary will constitute qualifying income.

[5] In December of 2010, the Chairman and Ranking Minority Member of the Senate Permanent Subcommittee on Investigations reported similar behavior to the IRS. *See id*.

regulatory oversight is completely at odds with the intent of the Dodd-Frank Act, the regulatory environment triggered by the 2007-08 financial crisis, and the CFTC-SEC jurisdictional boundaries that clearly delineate who has federal regulatory oversight and jurisdiction over derivatives transactions.

Given the use of derivatives by certain registered investment companies, NFA argued to the CFTC that one of the key premises for the CFTC's 2003 amendments to Rule 4.5 – that registered investment companies were "otherwise regulated" regarding their derivatives trading – is no longer true. *Id*. at 10. Based on this material change in the investment environment, NFA urged the CFTC to amend Rule 4.5 to restore the *de minimus* trading and no-marketing operating restrictions on registered investment companies in effect prior to 2003. *Id*. at 11. Indeed, only by rescinding the 2003 amendments could the CFTC – and also NFA itself – exercise regulatory oversight over registered investment companies that either engage in more than a *de minimus* amount of derivatives trading or market themselves to the public as vehicles for investing in derivatives. As NFA emphasized in its petition, the CFTC and NFA are the only regulatory bodies that have the experience, expertise, and jurisdiction to comprehensively and meaningfully regulate managed retail futures products. *Id*. at 10 ("The CFTC alone has the Congressional mandate to regulate retail managed futures trading and products, and over the years has developed the specialized body of skill and knowledge necessary to fulfill this mandate.").

NFA's petition had its desired effect. In February 2011, the CFTC issued a Notice of Proposed Rulemaking in which it cited the NFA's petition and proposed to amend Rule 4.5 to rescind or narrow several exemptions and exclusions, including the commodity pool operator exclusion for registered investment companies. 76 Fed. Reg. 7976, 7983-7984 (Feb. 11, 2011). The CFTC further noted that the proposed changes were designed to "bring the Commission's [commodity pool operator] . . . regulatory structure into alignment with the stated purposes of the Dodd-Frank Act." *Id*. at 7978. The definition of "commodity pool operator," as revised by Dodd-Frank, includes a subsection that permits the CFTC to exclude persons or entities from this

definition by rule or regulation if the CFTC determines that the exclusion will "effectuate the purposes of this [Act]." 7 U.S.C. §§ 1a(10)(B) and 1a(11)(B).[6]

On February 24, 2012, the CFTC issued the Final Rule that is the subject of Plaintiffs' challenge, amending Regulation 4.5 to re-impose the *de minimis* trading and no-marketing restrictions upon investment companies seeking to avail themselves of the commodity pool operator exclusion. *See* 77 Fed. Reg. 11252 (Feb. 24, 2012). The restrictions were similar to those that were rescinded in 2003, although the CFTC made several modifications based on comments it received in the rulemaking process. The CFTC made one particularly important modification – apparently in response to investment company commentators – specifically adopting an alternative *de minimis* trading restriction, which provides that an investment company's aggregate notional value of commodity futures, commodity options, and swaps cannot exceed 100% of a fund's net liquidating value. *See* Rule 4.5(c)(2)(iii)(B).[7]

The Final Rule also completely rescinded an exemption from CPO registration in Rule 4.13(a)(4), which had permitted private commodity pools to engage in an unlimited amount of commodity interest trading as long as the pool's participants met certain purported sophistication criteria. The Final Rule left in place, however, a 2003 *de minimis* exemption from CPO registration under Rule 4.13(a)(3). This exemption applies to private pools offered to investors meeting certain criteria, contains a no-marketing restriction, and includes *de minimis* trading restrictions similar to the two that the CFTC re-imposed in Rule 4.5. However, the trading restriction in Rule 4.13(a)(3) is more restrictive than Rule 4.5 because it includes transactions for bona-fide hedging purposes in the *de minimis* trading calculations.

[6] Among the amendments that the Dodd-Frank Act made to the CEA was the revision and renumbering of these sections; substantively, it changed the "commodity pool operator" definition to explicitly include swaps among its non-exclusive list of covered commodity interests. 7 U.S.C. § 1a(10).

[7] Additionally, in response to commenters' requests, the CFTC provided seven instructive factors to further explain the plain language of the no-marketing restriction. 77 Fed. Reg. 11252, 11258-11259 (Feb. 24, 2012).

The CFTC's Final Rule also recognizes the need to contain costs by harmonizing CFTC regulations with those of the SEC. In the same vein, the CFTC has also proposed certain disclosure, reporting, and record-keeping changes in an accompanying release. Although the comment period has closed, that rulemaking is still open. *See* 77 Fed. Reg. 11345 (Feb. 24, 2012). The CFTC utilized a similar harmonization process in 2011, when it adopted amendments to Rules 4.12 and 4.13 applicable to certain commodity exchange traded funds whose units of participation are listed and traded on a national securities exchange. 76 Fed. Reg. 28641 (May 18, 2011).

Finally, as part of a cost-benefit analysis, the CFTC identified in its final rulemaking various costs that registered investment companies will incur because of the elimination of the exclusion and the requirement that their investment advisers register as commodity pool operators. These costs include those associated with the CFTC registration process and fees for obtaining and maintaining membership in NFA. Most of these costs are *de minimis*, including, for example, initial registration fees of $85 and $220, annual NFA membership dues of $750, and other miscellaneous compliance costs. *See* NFA Rule 203; NFA Bylaw 1301. As demonstrated by its adoption of the Final Rule, the CFTC determined that the benefits of the Final Rule outweighed these costs of compliance.

D. The "SEC Concept Release" Relating to the Regulation of Derivatives

Not long after the CFTC announced its proposed rulemaking in 2011, the SEC separately announced that it was reviewing the use of derivatives by registered investment companies. It issued a request for comments "on a wide range of issues . . . including the potential implications for fund leverage, diversification, exposure to certain securities-related issuers, portfolio concentration, valuation, and related matters." SEC Concept Release, *Use of Derivatives by Investment Companies Under the Investment Company Act of 1940*, 76 Fed. Reg. 55237 (Sept. 7,

2011) (the "SEC Concept Release").[8] Investment companies are subject to the regulatory framework set forth in the Investment Company Act, a core purpose of which is to protect investors from the potential adverse effects of leverage. *See* 15 U.S.C. § 80a-1(b)(7) (stating that the national public interest and the interest of investors are adversely affected "when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities").[9]

The SEC's Concept Release explained that "[t]he dramatic growth in the volume and complexity of derivatives investments over the past two decades, and funds' increased use of derivatives, have led the [SEC] . . . to initiate a review of funds' use of derivatives under the Investment Company Act." 76 Fed. Reg. at 55238. The SEC specifically noted that "derivatives can raise risk management issues for a fund relating, for example, to leverage, illiquidity . . . , and counterparty risk, among others," and that the purpose of its review "is to evaluate whether the regulatory framework, as it applies to funds' use of derivatives, continues to fulfill the purposes and policies underlying the Act and is consistent with investor protection." *Id.* The SEC stated further that it "intends to consider the comments to help determine whether regulatory initiatives or guidance are needed to improve the current regulatory regime for funds." *Id.* at 55237.

[8] The SEC generally uses the phrases "investment company," "fund," and "mutual fund" interchangeably to refer to a specific type of registered investment company, the open-end management company.

[9] Before passage of the Investment Company Act, sponsors created complex capital structures and often used leverage, whether it was from money borrowed from a bank or from senior securities sold to investors, to dilute and degrade the investments made by the retail public in the fund's junior securities (i.e., common stock). The Investment Company Act's statutory limitation on leverage appears in Section 18, paragraph (f) of which prohibits an open-end management company from issuing a "senior security." 15 U.S.C. § 80a-18(f). The practical effect of Section 18(f) is to limit an open-end management company from borrowing from any person that is not a bank, and from borrowing an unlimited amount of money.

III. ARGUMENT

A. The CFTC Had The Authority To Issue The Final Rule, And Its Determinations Are Entitled To Substantial Deference

As the discussion above demonstrates, the CFTC's authority to issue the Final Rule cannot be questioned, which is presumably why plaintiffs do not base their challenge on that ground. The CEA gives the CFTC exclusive jurisdiction over most futures contracts, commodity options, and swaps. *See* 7 U.S.C. § 2(a)(1)(A).

Directly contradicting plaintiffs' claim that the CFTC's exercise of authority somehow conflicts with the SEC's authority, the plain language of the CEA does not carve out a regulatory exemption or exception for individuals or entities also registered with the SEC and subject to regulation by the SEC under the Investment Company Act. To the contrary, Section 1a(11)(B) gives the CFTC discretion as to who should be regulated as a commodity pool operator. The CFTC has discretion to exclude persons from the term "commodity pool operator" and its exercise of this discretion must be consistent with the purposes of the CEA, which include "to deter and prevent . . . disruptions to market integrity; to ensure the financial integrity of all transactions subject to [the CEA] and the avoidance of systemic risk; to protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets." 7 U.S.C. § 5(b). Here, the CFTC's decision to promulgate the Final Rule, which subjects registered investment companies that cannot meet the *de minimis* trading and no-marketing exclusion criteria to regulation by the CFTC, was a rational and prudent exercise of its obligation to carry out these critical purposes of the CEA.

Plaintiffs' contention that the CFTC's Final Rule violates the Administrative Procedure Act (the "APA"), 5 U.S.C. § 706, is governed by a highly deferential standard of review that recognizes the unique expertise of the CFTC. Under this standard, the Court may set aside the CFTC's action only if it was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." *Id*. § 706 (2)(A). While APA review is in general "very deferential" to the agency's conclusions, *Rural Cellular Ass'n v. FCC*, 588 F.3d 1095, 1105 (D.C. Cir. 2009), that is especially true where, "the decision under review requires expert policy judgment of a

technical, complex, and dynamic subject." *Cablevision Sys. Corp. v. FCC*, 597 F.3d 1306, 1311 (D.C. Cir. 2010). Regulation of the derivatives markets requires expert policy judgments in all of these areas; indeed, Congress recognized as much when it "overhaul[ed]" the CEA in 1974 "to institute a more 'comprehensive regulatory structure to oversee the volatile and esoteric futures trading complex.'" *CFTC v. Schor*, 478 U.S. 833, 836 (1986) (internal citation omitted).[10] In doing so, Congress vested the CFTC with "sweeping authority" and discretion "'to make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary *to effectuate any of the provisions or to accomplish any of the purposes of* [the CEA].'" *Id.* at 842 (quoting 7 U.S.C. § 12a(5)) (emphasis added by Supreme Court).

As demonstrated in the next section, plaintiffs cannot show that the CFTC's Final Rule is a valid exercise of the Commission's rulemaking authority and is neither arbitrary nor capricious.

B. The CFTC Reasonably And Prudently Acted To Close A Dangerous Gap In The Regulation Of Registered Investment Companies Investing In Derivatives

The CFTC is the only agency with the expertise and jurisdiction necessary to effectively regulate a registered investment company's trading in derivatives. The SEC has jurisdiction over certain limited types of derivatives. For example, the SEC has jurisdiction over securities-based swaps, and it shares jurisdiction with the CFTC over security futures and certain securities-based swaps called mixed-swaps. 7 U.S.C. §§ 1a(47)(D); 2(a)(1)(A) & 2(a)(10(D).

To the extent that the Investment Company Act provides the authority to place restrictions on the use of derivatives by registered investment companies, the record before the CFTC demonstrated that the present regulatory framework provided by the Investment Company Act is inadequate. The NFA petition provided specific examples of registered investment companies soliciting investments from retail customers for use in the derivatives market and

[10] This same deferential standard of review applies to the Commission's cost-benefit analysis under Section 15(a) of the Act, 7 U.S.C. § 19(a) (2006), which is discussed below. *Cf. Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (applying arbitrary and capricious standard to SEC mandate to consider the effect of a rule on "efficiency, competition, and capital formation"); *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010) (same).

cited instances in which the Investment Company Act's investor protection regime did not offer comparable regulatory protections as the CFTC's customer protection regime. Investment companies' use of wholly-owned subsidiaries that are not themselves directly regulated by any U.S. financial regulator to trade derivatives further exacerbated NFA's customer protection concerns. NFA Pet. 8-9.

The CFTC explicitly cited NFA's petition in explaining the basis for the Proposed Rulemaking:

> In 2010, the Commission became aware of certain registered investment companies that were offering series of de facto commodity pool interests claiming exclusion under § 4.5. The Commission consulted with market participants and NFA regarding this practice. Following this consultation, NFA submitted a petition for rulemaking in which NFA suggested certain revisions to § 4.5 with respect to registered investment companies.

76 Fed Reg. at 7983. Further, the CFTC incorporated this information by reference in its final rulemaking release. 77 Fed. Reg. at 11254.

Plaintiffs' suggestion that the Final Rule is duplicative of existing regulation under the Investment Company Act is baseless. That much should be clear from the examples cited in the NFA Petition, which formed part of the basis for the CFTC's ultimate decision to re-impose the *de minimis* and no-marketing restrictions in the Final Rule. If the examples cited in the NFA Petition were not enough, the fact that the SEC Concept Release is replete with questions regarding the scope and applicability of the present regulatory framework to derivatives should be dispositive. *See* SEC Concept Release.

To be clear, the Investment Company Act does not explicitly regulate derivatives at all. However, the SEC has interpreted Section 18(f) of the Investment Company Act as reaching certain types of derivatives. That Section prohibits a registered investment company that is an open-end management company from issuing a "senior security," defined as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of

assets or payment of dividends," except that such an investment company may borrow from a bank if it maintains 300% asset coverage over all such borrowings. 15 U.S.C. § 80a-18(f). In 1979, the SEC issued Investment Company Act Release No. 10666 ("Release No. 10666"), which interprets Section 18(f). *Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666*, 44 Fed. Reg. 25128 (Apr. 27, 1979). Because the signature characteristic of a derivative is the existence of leverage, Release No. 10666 reasons by analogy that the definition of "senior security" should include derivatives that function like evidences of indebtedness, where payment of principal or interest will stand in front of any dividends or other amounts that might otherwise be paid to owners of common shares, i.e., "externally" leveraged derivatives. *See id*; *see also* Guidelines for Preparation of Form N-8B-1, Investment Company Act Release No. 7221 (June 9, 1972), 37 Fed. Reg. 12790 (June 29, 1972).

Under this interpretation, Release No. 10666 could have prohibited registered investment companies from trading in derivatives that meet the "senior security" definition, except as in compliance with all of the prohibitions and restrictions set forth in Section 18(f). Instead, Release No. 10666 provides that investment companies that invest in "senior security"-type derivatives may "cover" such transactions by (1) setting aside, in a segregated account, assets equal in value to 100% of the fund's obligation; or (2) engaging in other transactions that offset the investment company's exposure.[11] Importantly, compliance with one of these requirements relieves an investment company from any obligation to comply with Section 18(f)'s prohibitions and restrictions.

Thus, even where Release No. 10666 applies to a transaction in derivatives, retail investors in the registered investment company have no reliable means of determining, for example, the volume of derivatives in which the registered investment company is trading, the

[11] Release No. 10666 required that the assets in the segregated accounts to cover these transactions be essentially riskless, i.e., cash, U.S. government securities, or very high grade debt instruments whose mark-to-market value was at least equal to the indebtedness the fund was exposed to through, for example, a reverse repurchase agreement. Release No. 10666, 10 n.4.

expectations of the performance of those derivatives, or the extent to which the registered investment company is leveraged in these transactions. Furthermore, Release No. 10666 provides no guidance at all in those instances where a registered investment company is engaging in derivatives transactions that cannot be characterized as a "senior security." Specifically, Release No. 10666 is silent on derivatives that are "internally" leveraged, i.e., where the effect of leverage is embedded within the instrument itself. As this description shows, contrary to plaintiffs' contention, the CFTC's Final Rule does *not* regulate issues already addressed by the SEC.

Moreover, the Investment Company Act's regulatory framework is ill-suited to address other issues that are inherent to derivatives transactions. For instance, the Investment Company Act requires every registered investment company to declare whether it is "diversified" or "undiversified." 15 U.S.C. § 80a-5(b). As the SEC Concept Release states, "[t]he purpose of the diversification requirements is to prevent a fund that holds itself out as diversified from being too closely tied to the success of one or a few issuers or controlling portfolio companies." SEC Concept Release at 49. A registered investment company's proper classification is based on the composition and value of the assets that it holds, including securities. However, determining the "value" of a security can be challenging if that security is a derivative. For example, how should a registered investment company properly value a swap agreement that involves a reference asset not owned by the investment company, but whose change in value drives the price of the swap agreement?

The difficulty of regulating derivatives under the Investment Company Act is further demonstrated by the requirements of Section 12(d)(3) of that Act, which prohibit a registered investment company from investing in any security issued by, or holding any other interest in, the business of a broker-dealer, underwriter, or registered investment adviser. 15 U.S.C. § 80a-12(d)(3). This section reflects a congressional policy of prohibiting investment companies from investing in securities-related businesses in order to prevent conflicts of interest and inappropriate reciprocal practices. Release No. 29776 at 57; Rule 12d3-1, 17 C.F.R. § 270.12d3-

1 (2012). The SEC Concept Release points out, however, that whether Section 12(d)(3) will apply depends on whether the derivative is exchange-traded, in which case the counterparty is the clearinghouse; whether it is a security issued by the counterparty; or whether the correct analysis is the degree of exposure to a reference asset underlying the derivative. In short, the SEC Concept Release itself convincingly demonstrates that the Investment Company Act is not, and was not intended to be, a comprehensive framework for the regulation of derivatives by registered investment companies.

Finally, by giving the CFTC and the SEC concurrent jurisdiction over certain types of derivatives transactions and instruments, Congress has indicated its intent that individuals and entities who engage in derivatives trading may be subject to regulation by both agencies. Congress could create a statutory exception in the CEA's definition of "commodity pool operator" for individuals and entities that are registered with the SEC or another financial regulatory agency, but it never has. In fact, on several occasions, the SEC has attempted to have withdrawn from the CFTC's jurisdiction areas in which they overlap, but Congress rejected those proposals. *See Bd. of Trade v. SEC*, 677 F.2d 1137 (7th Cir. 1982), *vacated as moot*, 459 U.S. 1026 (1982). Instead, Congress has left the question of who will be subject to CFTC regulation as a commodity pool operator to the CFTC's discretion, empowering the CFTC to exclude individuals and entities when doing so would further the CEA's purposes. 7 U.S.C. §§ 1a(11)(A), 5(b). If entities properly regulated by the CFTC and the SEC find complying with the regulations promulgated by both agencies unduly burdensome, they may seek a legislative remedy. It is not, however, "arbitrary or capricious" for the CFTC to exercise the regulatory authority bestowed upon it by Congress to oversee derivatives transactions engaged in by registered investment companies.

C. The *De Minimis* And No-Marketing Tests Are A Reasonable Exercise Of The Commission's Jurisdiction

The CFTC's re-imposition of *de minimis* trading and no-marketing requirements is a reasonable response to the problem identified in NFA's Petition, and the tests themselves are

reasonable methods for distinguishing between those registered investment companies that are using derivatives as a significant part of their investment strategies and those that are not.

The 5% test at issue in this proceeding is more liberal than the test in the 1985 rules, and the addition of the aggregate net notional value alternative test makes the recently adopted rule more liberal than the version in effect between 1993 and 2003. The 1985 and 1993 versions of the test covered all products within the CFTC's jurisdiction at the time; the 2003 expansive exclusion for essentially all registered investment companies is less than ten years old and was the product of a fundamentally different investment environment in which derivatives trading was nowhere near as prevalent as it is today. At the time the CFTC enacted the 2003 amendments, there was a movement toward financial deregulation. The devastating crisis in the financial markets in 2007-2008 has been attributed, at least in part, to that very movement. *See* CFTC Mot. 20 (ECF No. 15). Furthermore, the CFTC had before it direct evidence that some registered investment companies have been selling de facto commodity pool investments to retail investors without providing those investors with the disclosures that the CFTC deems essential.

Nor are the *de minimus* trading and no-marking tests unduly restrictive. The 5% test allows registered investment companies to enter into speculative positions and risk management strategies not considered bona fide hedges. Additionally, this test is entirely consistent with – although slightly broader than – the *de minimis* standards for private pools that the CFTC adopted in 2003. *See* Rule 4.13(a)(3). Registered investment companies whose investments exceed the threshold are engaged in significant transactions that are not merely incidental to their other investment activities. Additionally, Rule 4.5(c)(2)(iii)(B)'s alternative aggregate net notional value test would allow a registered investment company to put all of its equity at risk in the derivatives markets.

The no-marketing test is also consistent with the purposes of the Act, and the CFTC provided express guidance as to what may constitute marketing to assist investment companies in assessing compliance with this restriction. The Act defines a commodity pool as a collective investment vehicle "operated for the purpose of trading in commodity interests." 7 U.S.C. §

1a(10)(A). If a registered investment company is soliciting investors to trade commodity interests, then there is no logical reason why the investment adviser to that registered investment company should not be regulated as a commodity pool operator.

In sum, the CFTC's Final Rule is a reasonable response to the problems identified in NFA's Petition. For investors in registered investment companies that cannot meet Rule 4.5's *de minimis* trading and no-marketing restrictions, the Final Rule ensures that they will have disclosures that are critical to informed investment decisions. The Court should reject plaintiffs' request to second-guess this determination by the expert agency charged with regulating the highly complex area of derivatives trading.

D. The Final Rule Provides Substantial And Meaningful Protection To Investors At Minimal Cost To Investment Advisers To Affected Registered Investment Companies

The validity and rationality of the CFTC's Final Rule is also amply demonstrated by a cost-benefit analysis. As described above, requiring CFTC registration by registered investment companies that cannot qualify for the exclusion as set forth in the Final Rule will provide substantial and meaningful benefit to investors and help to protect the market against systemic risk, thereby advancing the purposes of the CEA. Without CFTC registration, neither the Commission nor NFA will have any oversight over registered investment companies engaging in derivatives transactions, regardless of the extent of that activity, thereby putting investors at risk. With the implementation of the Final Rule, investment advisers to affected registered investment companies will be subject to the CFTC's harmonized customer disclosure, recordkeeping, and reporting requirements applicable to commodity pool operators. NFA will also have the ability to examine these investment advisers for compliance with the commodity pool operator regulatory requirements, which include disclosure related to fees and costs, sales practices, promotional material, accounting practices, financial recordkeeping, and risk management practices—all of which provide substantial and meaningful protection to retail investors thus far

largely kept in the dark about the derivatives practices of these registered investment companies.[12]

Plaintiffs' assertion that investment advisers will incur substantial additional operating costs if they are required to become members of NFA (as all CFTC-registered commodity pool operators are) is simply overblown. *See* MFDF Amicus Br. 12-13 (ECF No. 12). In particular, if a registered investment company is presently investing more than a *de minimus* amount in derivatives, its board of directors – in the exercise of its fiduciary duty – may well have already ensured that the investment adviser and/or investment company has compliance personnel who are qualified in derivatives transactions and regulations. Moreover, investment advisers to registered investment companies should already have many, if not all, of the regulatory requirements mandated by NFA in place. For example, it is difficult to imagine that an investment adviser would not already have established disaster-recovery or business continuity plans for itself and the registered investment companies that it advises. *See* NFA Rule 2-38.[13] And, as described above, other costs associated with NFA-membership are minimal.

Finally, the CFTC is taking affirmative steps to ensure that plaintiffs' concerns about duplicative regulatory requirements are not realized. To this end, the CFTC has proposed harmonizing its commodity pool operator requirements for investment advisers to registered investment companies with the rules under the Investment Company Act in the areas of recordkeeping, disclosure, and reporting. *See* 77 Fed. Reg. 11345 (Feb. 24, 2012). In view of this action, complaints about duplicative regulatory regimes are premature and fail to recognize the CFTC's prior success in a similar harmonization process applicable to commodity pool

[12] Although the Investment Company Act requires similar disclosures for entities that are subject to its jurisdiction, in several instances, the SEC-required disclosures do not require the same level of detail as the CFTC's requirements. For example, the Investment Company Act does not require transparency regarding fees being charged as mandated by the CFTC's break-even point fee disclosure nor the disclosure of the investment adviser's past performance for similarly offered vehicles.

[13] Except where otherwise noted, all of the NFA rules and bylaws referenced in this Brief can be found in NFA's Manual, available on NFA's website at http://www.nfa.futures.org/nfamanual/NFAManual.aspx.

operators in the context of CFTC-SEC dually regulated commodity pool exchange-traded funds whose units of participation are listed and traded on a national securities exchange, and constitute securities offered under the Securities Act of 1933. *See* 76 Fed. Reg. 28641 (May 18, 2011).

IV. CONCLUSION

Congress has entrusted the Commission with primary regulation of the derivatives markets, and it has developed substantial expertise in those markets. This court should honor that expertise and affirm the Commission's actions in adopting the amendments to Rule 4.5.

DATED: June 25, 2011

Respectfully submitted,

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