ORAL ARGUMENT NOT YET SCHEDULED

No. 12-5413

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

INVESTMENT COMPANY INSTITUTE and
CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA,

Appellants,

v.

UNITED STATES COMMODITY FUTURES TRADING COMMISSION,

Appellee.

On Appeal From The United States District Court
For The District Of Columbia

BRIEF FOR APPELLANTS

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CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

Pursuant to D.C. Circuit Rule 28(a)(1)(A), Appellants Investment Company Institute ("ICI") and Chamber of Commerce of the United States of America ("the Chamber") state as follows:

(A) Parties and Amici:

The parties in this case are Investment Company Institute (Appellant), the Chamber of Commerce of the United States of America (Appellant), and the United States Commodity Futures Trading Commission (Appellee).

The Mutual Fund Directors Forum ("MFDF") has indicated its intention to submit a brief as *amicus curiae* in this Court.

Before the district court, the following entities submitted briefs as *amicus curiae*: MFDF, the National Futures Association, and Better Markets, Inc.

(B) Rulings Under Review:

Appellants have sought review of the district court's opinion and order issued December 12, 2012, in *Investment Company Institute v. CFTC*, No. 12-cv-612 (D.D.C.).

(C) Related Cases:

Appellants are not aware of any cases related to this appeal.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure, Appellants Investment Company Institute ("ICI") and Chamber of Commerce of the United States of America ("the Chamber") state as follows:

1. Appellant ICI is a non-profit, tax-exempt organization incorporated in the State of Delaware.

2. Appellant the Chamber is a non-profit, tax-exempt organization incorporated in the District of Columbia.

3. Appellants are each non-stock corporations and have no parent organizations.

4. Because Appellants are non-stock corporations, no publicly held corporations hold 10% or more of their stock.

5. Appellants are unaware of any publicly held corporation that is not a party to the proceeding before this Court that has any direct financial interest in the outcome of this proceeding.

TABLE OF CONTENTS

Page

INTRODUCTION 1

JURISDICTIONAL STATEMENT 4

STATEMENT OF ISSUES 4

STATUTORY AND REGULATORY PROVISIONS INVOLVED 5

STATEMENT OF THE CASE..5

STATEMENT OF FACTS 6

A. Regulation of Registered Investment Companies 6

B. Regulation of Commodity Pool Operators..10

C. The Commission's Amendments to Section 4.5 13

D. The District Court Proceedings 25

SUMMARY OF ARGUMENT 25

STANDING 28

STANDARD OF REVIEW 28

ARGUMENT 29

I. The Commission Arbitrarily Reversed Its Prior Rulemaking With No Meaningful Justification. 29

II. The Commission's Assessment Of Costs And Benefits Violated Both The Administrative Procedure Act And The Commodity Exchange Act..38

A. Because The Commission Failed To Assess Existing Regulation, The Commission Could Not Know Whether Its Rule Afforded Any Benefits. 39

B. The Commission Relied On Specific Purported Benefits Not Supported By Its Analysis. 48

C. The Commission Made It Impossible To Fully Determine The Costs And Benefits Of Its Rule, As Required By Law. 51

III. The Commission Failed To Provide A Reasoned Justification For Significant Aspects Of Its Rule. 59

IV. The Commission Failed To Afford Adequate Opportunity For Notice And Comment. 64

V. The Rule's Deficiencies Require Vacatur. 65

CONCLUSION 67

TABLE OF AUTHORITIES

Cases **Page(s)**

AFL-CIO v. Donovan,
757 F.2d 330 (D.C. Cir. 1985)....................65

Allied-Signal, Inc. v. Nuclear Regulatory Comm'n,
988 F.2d 146 (D.C. Cir. 1993)....................66

* *Am. Equity Inv. Life Ins. Co. v. SEC*,
613 F.3d 166 (D.C. Cir. 2010).................... 2, 26, 38, 39, 40, 42, 43, 46, 47, 66

Burks v. Lasker,
441 U.S. 471 (1979)....................9

* *Bus. Roundtable v. SEC*,
647 F.3d 1144 (D.C. Cir. 2011).................... 2, 26, 29, 38, 39, 42, 43, 46, 48

* *Chamber of Commerce v. SEC*,
412 F.3d 133 (D.C. Cir. 2005).................... 38, 47, 51

Chamber of Commerce v. SEC,
443 F.3d 890 (D.C. Cir. 2006)....................65

Dillmon v. NTSB,
588 F.3d 1085 (D.C. Cir. 2009)....................29

FCC v. Fox Television Stations, Inc.,
129 S. Ct. 1800 (2009).................... 25, 30

Gas Appliance Mfrs. Ass'n v. Dep't of Energy,
998 F.2d 1041 (D.C. Cir. 1993)....................28

* *Int'l Ladies' Garment Union v. Donovan*,
722 F.2d 795 (D.C. Cir. 1983)....................32

Int'l Swaps and Derivatives Ass'n v. CFTC,
— F. Supp. 2d —, No. 11-cv-2146 RLW, 2012 WL 4466311
(D.D.C. Sept. 28, 2012).................... 24, 62

La. Fed. Land Bank Ass'n v. FCA,
336 F.3d 1075 (D.C. Cir. 2003)....................41

La. Pub. Serv. Comm'n v. FERC,
522 F.3d 378 (D.C. Cir. 2008)....................56

Manin v. NTSB,
627 F.3d 1239 (D.C. Cir. 2011)....................29

Milk Train, Inc. v. Veneman,
310 F.3d 747 (D.C. Cir. 2002)....................66

Mobile Oil Corp. v. EPA,
35 F.3d 579 (D.C. Cir. 1994)....................63

Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.,
463 U.S. 29 (1983).................... 29, 33, 47

* *Nat'l Fuel Gas Supply Corp. v. FERC*,
468 F.3d 831 (D.C. Cir. 2006).................... 29, 47, 66

NRDC v. EPA,
489 F.3d 1250 (D.C. Cir. 2007).................... 65, 66

Owner-Operator Indep. Drivers Ass'n v. FMCSA,
494 F.3d 188 (D.C. Cir. 2007)....................32

* *Rio Grande Pipeline Co. v. FERC*,
178 F.3d 533 (D.C. Cir. 1999).................... 36, 56

* *SEC v. Chenery Corp.*,
318 U.S. 80 (1943).................... 29, 36, 58

Sierra Club v. EPA,
292 F.3d 895 (D.C. Cir. 2002)....................28

Solite Corp. v. EPA,
952 F.2d 473 (D.C. Cir. 1991)....................63

Syncor Int'l Corp. v. Shalala,
127 F.3d 90 (D.C. Cir. 1997)....................63

Troy Corp. v. Browner,
120 F.3d 277 (D.C. Cir. 1997).....28

Wheaton Van Lines, Inc. v. ICC,
671 F.2d 520 (D.C. Cir. 1982).....38

Williams Gas Processing-Gulf Coast Co. v. FERC,
475 F.3d 319 (D.C. Cir. 2006).....31

Statutes

5 U.S.C. § 553.....64

5 U.S.C. § 706.....29, 65

7 U.S.C. § 1a(11).....10

7 U.S.C. § 6m.....10

* 7 U.S.C. § 19(a).....19, 32, 38

7 U.S.C. § 21(m).....10

15 U.S.C. § 77b(b).....38

15 U.S.C. § 78c(f).....38

15 U.S.C. § 80a-2.....9, 38, 44

15 U.S.C. § 80a-3(a)(1).....6

15 U.S.C. § 80a-8(b).....8, 10

15 U.S.C. § 80a-9.....50

15 U.S.C. § 80a-10(a).....9, 44

15 U.S.C. § 80a-12(d)(3).....10

15 U.S.C. § 80a-13(a)(3).....10

15 U.S.C. § 80a-17.....10

15 U.S.C. § 80a-18 .... 8, 44

15 U.S.C. § 80a-29 .... 8, 10, 49

15 U.S.C. § 80a-30 .... 9, 50

15 U.S.C. § 80a-41 50

15 U.S.C. § 80a-48 50

15 U.S.C. § 80b-2(a)(11) 6

15 U.S.C. § 80b-3 .... 8, 50

15 U.S.C. § 80b-4 50

15 U.S.C. § 80b-9 50

15 U.S.C. § 80b-14 50

28 U.S.C. § 1291 4

28 U.S.C. § 1331 4

44 U.S.C. § 3501(1) 53

44 U.S.C. § 3507 .... 22, 53

Pub. L. No. 111-203, 124 Stat. 1376 (2010) 35, 47, 50, 60

Regulations

17 C.F.R. § 1.3(z)(1) 61

17 C.F.R. § 3.12(h)(1)(ii) 9, 50

17 C.F.R. § 4.21 10

17 C.F.R. § 4.22 10

17 C.F.R. § 4.23 10

17 C.F.R. § 4.24 10

17 C.F.R. § 4.25 10

17 C.F.R. § 151.5 61

17 C.F.R. § 210.12 .... 8, 36

17 C.F.R. § 210.13 .... 8, 36, 44

17 C.F.R. § 270.12d3-1 10

17 C.F.R. § 270.30b1-5 8

17 C.F.R. § 270.30b2-1 8

17 C.F.R. § 270.30e-1 8

17 C.F.R. § 270.31a-1 9

Other Authorities

44 Fed. Reg. 25,128 (Apr. 27, 1979) 44

50 Fed. Reg. 15,868 (Apr. 23, 1985) 11

61 Fed. Reg. 66,207 (Dec. 17, 1996) 44

* 68 Fed. Reg. 12,622 (Mar. 17, 2003) 63

* 68 Fed. Reg. 47,221 (Aug. 8, 2003) 12, 31, 32, 64

74 Fed. Reg. 3,138 (Jan. 16, 2009) 42

74 Fed. Reg. 29,024 (Jun. 18, 2009) 43

75 Fed. Reg. 54,794 (Sept. 9, 2010) 11

76 Fed. Reg. 7,976 (Feb. 11, 2011) 13, 34, 64, 65

76 Fed. Reg. 55,237 (Sept. 7, 2011) 45, 46

77 Fed. Reg. 1,182 (Jan. 9, 2012) 37

77 Fed. Reg. 2,136 (Jan. 13, 2012) 37

77 Fed. Reg. 11,252 (Feb. 24, 2012) 5, 13, 14, 15, 17, 18, 19, 20, 21, 22, 23, 24, 31, 40, 41, 43, 46, 48, 49, 52, 53, 54, 57, 58, 60, 61, 62, 64, 65

77 Fed. Reg. 11,345 (Feb. 24, 2012) 6, 23, 55

77 Fed. Reg. 17,328 (Mar. 26, 2012)..5

Cmte. on Fed. Regulation of Securities, ABA, *Report of the Task Force on Investment Company Use of Derivatives and Leverage* (2010)...... 9, 44, 45

Dreyfus Strategic Investing & Dreyfus Strategic Asset Management, L.P., SEC No-Action Letter (pub. avail. Jun. 22, 1987) 9, 44

Exec. Order No. 13,563 (Jan. 18, 2011) 40

H.R. Rep. No. 104-37 (1995)..53

Clifford E. Kirsch, *Mutual Funds and Exchange Traded Funds Regulation* (3d ed. 2011) 7

Letter from Barry D. Miller, Associate Director, Office of Legal and Disclosure, to Karrie McMillan, General Counsel, Investment Company Institute (July 30, 2010) 8, 44

Louis Loss et al., *Securities Regulation* (4th ed. 2006) 7

Merriam-Webster Collegiate Dictionary (10th ed. 1993) 38

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S. Rep. No. 111-176 (2010)..37

GLOSSARY

APA	Administrative Procedure Act
CFTC or the Commission	Commodity Futures Trading Commission
CEA	Commodity Exchange Act
CPO	Commodity Pool Operator
FINRA	Financial Industry Regulatory Authority
IAA	Investment Advisers Act of 1940
ICA	Investment Company Act of 1940
ICI	Investment Company Institute
NFA	National Futures Association
PRA	Paperwork Reduction Act
SEC	Securities and Exchange Commission
The Chamber	Chamber of Commerce of the United States of America

INTRODUCTION

Mutual funds and other investment companies are among the most comprehensively regulated entities in the U.S. financial system. The Securities and Exchange Commission ("SEC") regulates practically every aspect of their business, as well as the investment advisers that manage them. Other service providers to investment companies are regulated both by the SEC and by the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory organization for the securities industry. For this reason, the Commodity Futures Trading Commission ("CFTC" or the "Commission") concluded in a 2003 rulemaking that investment companies were "otherwise regulated" entities that did not require regulation by the CFTC. The Commission also found that exempting investment companies from CFTC regulation would encourage their participation in the commodity markets, yielding greater liquidity and market efficiency.

This case concerns the Commission's reversal of that 2003 decision. In 2012, the Commission imposed a registration requirement similar in most respects to the one eliminated in 2003, yet failed to acknowledge its rationale for the 2003 rulemaking—much less explain why it no longer found the facts and circumstances underlying that rulemaking to be compelling. Indeed, although the Commission found in 2003 that eliminating the registration requirement would promote liquidity in the commodity markets, the Commission has never—to this day—explained

the effect on liquidity that it believes re-imposing the registration requirement will have or attempted to weigh that effect against any purported benefits of the requirement.

The Commission—notwithstanding its reliance in 2003 on the "otherwise regulated" nature of investment companies—likewise failed to assess existing regulation by the SEC and FINRA to determine whether there is any need for additional regulation. This failure is fatal to the rulemaking under *American Equity Investment Life Insurance Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010), and *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011), both of which vacated SEC regulations based on that agency's failure to adequately consider the "baseline" of protection afforded by existing regulation. The cost-benefit provision of the Commodity Exchange Act ("CEA") requires the Commission to "consider" and "evaluate" the costs and benefits of a rule; the Commission could not meaningfully carry out that responsibility without assessing the protections already afforded.

Moreover, the Commission's failure adequately to consider the existing regulation of investment companies led it to rely on purported benefits that will not, in fact, be provided by its rule. The Commission repeatedly invoked "two significant benefits" of the rule: to promote the fitness and competency of registered entities, and to provide a means to address wrongdoing by market participants. Yet both "significant benefits" are *already* provided by the SEC and FINRA. Indeed, pre-

cisely because the SEC comprehensively regulates investment companies, the Commission has suspended application of significant portions of its regulations pending a separate rulemaking intended to "harmonize" the SEC and CFTC regimes. The Commission counted application of those suspended regulations as among the "benefits" of its rule, even as it simultaneously disregarded their potential costs on the ground that those costs cannot be determined until after harmonization. The Commission's analysis thus systematically undercounted the rule's potential costs, while overstating its benefits.

Rather than address the substance of these rulemaking deficiencies, the Commission throughout this litigation has responded with generalized invocations of the financial crisis and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The district court's opinion below mirrors that approach in upholding the rule. Yet neither the Commission nor the district court explained why those circumstances justify the *particular* regulatory provisions at issue here. Both relied on a change in regulatory "philosophy" supposedly ushered in by recent events, but whatever the Commission's regulatory philosophy, it was required to comply with the cost-benefit provision of the CEA and to address the facts and circumstances that underlay its 2003 rulemaking. Because the Commission failed to meet those obligations, its amendments to Section 4.5 should be vacated, and the district court's decision should be reversed.

JURISDICTIONAL STATEMENT

The district court had jurisdiction under 28 U.S.C. § 1331. *See* Order, *ISDA v. CFTC*, No. 11-1469 (D.C. Cir. Jan. 20, 2012). This Court has jurisdiction pursuant to 28 U.S.C. § 1291.

STATEMENT OF ISSUES

1. Whether the Commission arbitrarily and capriciously failed to address the facts and circumstances that underlay its 2003 rulemaking, including its prior finding that eliminating registration thresholds would provide increased liquidity.

2. Whether the Commission acted arbitrarily and capriciously, and in violation of the cost-benefit provision of the CEA, when it failed to assess the baseline of protection afforded by existing regulation and promulgated its rule in a manner that made it impossible to meaningfully determine the rule's costs and benefits, and when it repeatedly failed to address significant comments and alternatives presented by commenters.

3. Whether the Commission acted arbitrarily and capriciously when it declined to exclude swap transactions from the registration threshold on the ground that it did not know how to write such a rule, adopted a restrictive definition of *bona fide* hedging without explaining why it was rejecting proposed alternatives, and failed to provide a reasoned justification for setting the registration threshold at five percent.

4. Whether the Commission provided an inadequate opportunity for notice and comment.

5. Whether the numerous deficiencies in the rulemaking process warrant vacatur of the Commission's rule.

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The statutory and regulatory provisions pertinent to this appeal are reproduced in the Addendum to this brief.

STATEMENT OF THE CASE

This case involves a final rule amending Section 4.5 of the Commission's regulations to require certain advisers to investment companies already registered with the SEC also to register with the CFTC as commodity pool operators. *See* 77 Fed. Reg. 11,252 (Feb. 24, 2012) ("the Rule"); *see also* 77 Fed. Reg. 17,328 (Mar. 26, 2012). The Rule's registration requirement became effective on December 31, 2012; its effective-date provision further states that "[e]ntities required to register due to the amendments to [Section] 4.5 shall be subject to the Commission's recordkeeping, reporting, and disclosure requirements pursuant to part 4 of the Commission's regulations within 60 days following the effectiveness of" a separate rulemaking designed to "harmoniz[e]" SEC and CFTC regulations. 77 Fed. Reg. at 11,252. A notice of proposed rulemaking in the harmonization proceeding

was published on February 24, 2012, but no final rule has issued in that proceeding. *See* 77 Fed. Reg. 11,345 (Feb. 24, 2012).

Appellants Investment Company Institute and Chamber of Commerce of the United States of America (together, "Appellants") filed their complaint in district court on April 17, 2012. The parties filed cross-motions for summary judgment. Oral argument was held October 5, and the district court issued its opinion and order upholding the Rule on December 12. Appellants filed their notice of appeal on December 27.

STATEMENT OF FACTS

A. Regulation of Registered Investment Companies

Investment companies—including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts—pool money from investors to purchase securities and other investments. *See* 15 U.S.C. § 80a-3(a)(1). An investment adviser manages the investment company for the benefit of investors. *See id.* § 80b-2(a)(11). Investment companies also contract with other service providers, including underwriters that distribute investment company shares for sale.[1]

Investment companies are required to register with the SEC, and are the only entities in the American financial system regulated under all four major federal se-

[1] For a discussion of the structure of investment companies, including differences between types of investment companies, *see* ICI Factbook, Appendix A, http://www.icifactbook.org/fb_appa.html.

curities laws: the Investment Company Act of 1940 ("ICA"), 15 U.S.C. § 80a-1 *et seq.*, the Investment Advisers Act of 1940 ("IAA"), 15 U.S.C. § 80b-1 *et seq.*, the Securities Act of 1933, 15 U.S.C. § 77a *et seq.*, and the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* They are among the "most regulated types of companies in the United States." 1 Clifford E. Kirsch, *Mutual Funds and Exchange Traded Funds Regulation* § 1:4.1 (3d ed. 2011); *see also* 1 Louis Loss et al., *Securities Regulation* 379 (4th ed. 2006) ("[T]he Investment Company Act is the most complex of the entire SEC series.").

Distributors of investment company shares are also subject to the regulatory oversight of FINRA, a self-regulatory organization with extensive authority and responsibility conferred by federal law. FINRA licenses individuals and firms that distribute shares in investment companies, issues substantive regulations, and disciplines licensed entities that fail to comply with the securities laws or with FINRA's own rules.

The SEC and FINRA subject investment companies and their service providers to myriad regulations covering virtually every aspect of investment companies' business, including their use of derivative instruments regulated by the CFTC:

Registration and Disclosure. Investment companies and their advisers are required to file registration statements containing disclosures on a broad va-

riety of topics, including fundamental characteristics and investment risks of the fund, investment strategies, past performance, and financial highlights. *See* 15 U.S.C. §§ 80a-8(b), 80b-3; *see also* Forms N-1A, N-2, and ADV. The SEC has specifically emphasized the importance of providing "understandable disclosures related to derivatives." Letter from Barry D. Miller, Associate Director, Office of Legal and Disclosure, to Karrie McMillan, General Counsel, Investment Company Institute 7 (July 30, 2010) ("Miller Letter").

Periodic Reporting. Investment companies are required to file quarterly, semi-annual, and annual reports containing financial information and other disclosures—including a list of all open derivatives positions on a contract-by-contract basis. Semi-annual and annual reports are provided to investors. *See* 15 U.S.C. § 80a-29; 17 C.F.R. §§ 210.12-13, 270.30b1-5, 270.30b2-1, 270.30e-1.

Limitations on Leverage. Investment companies are subject to restrictions intended to limit risk associated with leverage—that is, transactions that could result in a loss greater than the amount initially invested. 15 U.S.C. § 80a-18. These restrictions have long applied to certain derivatives transactions, including swaps. *See* Dreyfus Strategic Investing & Dreyfus Strategic

Asset Management, L.P., SEC No-Action Letter (pub. avail. Jun. 22, 1987) ("Dreyfus Letter").

Independent Board Oversight. Independent directors serve as "watchdogs" and furnish an independent check on the management of the fund. *Burks v. Lasker*, 441 U.S. 471, 480-84 (1979); *see also* 15 U.S.C. §§ 80a-10(a), 80a-2(a)(19). Board oversight includes responsibility to ensure that the "investment manager has the capacity to measure and monitor a fund's risk exposures generally, and from the use of derivatives in particular." Cmte. on Fed. Regulation of Securities, ABA, *Report of the Task Force on Investment Company Use of Derivatives and Leverage* 45 (2010), *available at* http://apps.americanbar.org/buslaw/blt/content/ibl/2010/08/0002.pdf ("ABA Rpt.").

Qualifications Testing. FINRA requires individuals who distribute investment company shares to pass competency examinations. *See* FINRA Rule 1230. The CFTC largely exempts persons who are subject to qualifications testing by FINRA from additional qualifications testing by the National Futures Association ("NFA"). *See* 17 C.F.R. § 3.12(h)(1)(ii).

Additional provisions—broadly applicable to *all* investment company activities, including derivatives trading—impose requirements governing recordkeeping (15 U.S.C. § 80a-30 and 17 C.F.R. § 270.31a-1), auditing of financial statements (15

U.S.C. § 80a-29(g)), affiliated transactions (*id.* § 80a-17), portfolio concentration (*id.* §§ 80a-8(b)(1)(E), 80a-13(a)(3)), and counterparty credit exposure (*id.* § 80a-12(d)(3) and 17 C.F.R. § 270.12d3-1).

B. Regulation of Commodity Pool Operators

A commodity pool operator ("CPO") is an entity that pools money from investors "for the purpose of" trading in commodity interests. *See* 7 U.S.C. § 1a(11)(A). The CFTC has statutory authority to exclude entities from the definition of a CPO, and hence from the registration requirement. *See id.* § 1a(11).

Entities that meet the statutory definition of a CPO and that are not excluded by the CFTC are subject to a regulatory regime administered by the CFTC that covers substantially the same areas as the SEC's regulation of investment companies. CPOs must register with the CFTC (7 U.S.C. § 6m), and are subject to provisions governing disclosure (17 C.F.R. §§ 4.21, 4.24-25), periodic reporting (*id.* § 4.22), auditing of financial statements (*id.*), and recordkeeping (*id.* § 4.23). In addition, registered CPOs are required to become members of the self-regulatory organization for the commodities industry: the NFA. *See* 7 U.S.C. § 21(m). Like FINRA, the NFA has authority to promulgate rules and regulations for its members and to enforce compliance, including through suspension or disbarment. The NFA imposes reporting and disclosure obligations, restrictions on the content of promotional materials, and qualification testing of associated persons.

Since 1985, the Commission has exercised its authority, through Section 4.5 of its regulations, to exempt a wide variety of "otherwise regulated" entities—including registered investment companies, banks, trust companies, insurance companies, and pension plans—from these regulatory burdens. *See* 50 Fed. Reg. 15,868 (Apr. 23, 1985). Just two years ago, the Commission reiterated that it had excluded these entities from its regulation of CPOs because they were "otherwise highly-regulated." 75 Fed. Reg. 54,794, 54,795 (Sept. 9, 2010).

Before 2003, Section 4.5 of the Commission's regulations required persons claiming exclusion for any of these otherwise regulated entities to file a notice of eligibility representing that they met two threshold requirements, referred to as the "trading" and "marketing" thresholds. Investment companies generally responded to these requirements by restricting their investments in commodity interests to comply with the thresholds, thus avoiding being subject to the overlapping regulatory jurisdiction of both the SEC and CFTC. *See*, *e.g.*, David E. Riggs & Charles C.S. Park, *Mutual Funds: A Banker's Primer*, 112 Banking L.J. 757, 760-61 (1995) ("While mutual funds can, and do, invest in commodity futures contracts, their investments in such contracts are limited so as to avoid classification and regulation as [CPOs].").

The Commission amended Section 4.5 in 2003 to eliminate the trading and marketing thresholds—effectively excluding all entities covered by that regulation

from the definition of a CPO. *See* 68 Fed. Reg. 47,221, 47,231 (Aug. 8, 2003) ("2003 Adopting Release"). Regulation of these entities was unnecessary, the Commission determined, because they are "otherwise regulated." *Id.* at 47,223. The Commission's amendments were "intended to allow greater flexibility and innovation" by "modernizing the requirements for determining who should be excluded from the CPO definition," and the change would "encourage and facilitate participation in the commodity markets by additional collective investment vehicles and their advisers, with the added benefit to all market participants of increased liquidity." *Id.*

The Commission's 2003 analysis of costs and benefits identified several benefits and no costs. The amendments would "benefit efficiency and competition by removing barriers to participation in the commodity interest markets, resulting in greater liquidity and market efficiency." 2003 Adopting Release at 47,230. The amendments would also "increase the available range of risk management alternatives" by permitting investment companies to take advantage of a wider range of trading strategies, thus promoting sound risk management practices. *Id.* Conversely, the Commission concluded that there "should be no decrease in the protection of market participants and the public" because the amendments were intended to adjust the Commission's regulations to "be consistent with existing requirements under the federal securities laws and the SEC's rules." *Id.*

C. The Commission's Amendments to Section 4.5

In the rulemaking at issue here, the Commission amended Section 4.5 to impose trading and marketing thresholds for investment companies even stricter than those it eliminated in 2003. The Commission, however, did not reimpose trading and marketing thresholds on entities covered by Section 4.5 other than registered investment companies.

Under the trading threshold imposed by the Rule, a person claiming exclusion may represent that the investment company uses futures, options, and swaps for *bona fide* hedging purposes—defined, by reference to other CFTC regulations, as risk-reduction transactions designed to offset exposure in the physical marketing channel. 77 Fed. Reg. at 11,283. With respect to non-*bona fide* hedging positions, a person may represent that, after taking into account unrealized profits and unrealized losses, either (1) the initial margins and premiums required to establish such positions in futures, options, and swaps will not exceed five percent of the liquidation value of the investment company's portfolio; or (2) under an "alternative net notional test," the "aggregate net notional value" of such positions "does not exceed 100 percent of the liquidation value of the pool's portfolio." *Id.* This largely mirrors the pre-2003 trading threshold, except that the net notional test is new.[2]

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[2] The net notional test was not in the initial proposal, *see* 76 Fed. Reg. 7,976, 7,989 (Feb. 11, 2011), but was added to the final rule without opportunity for pub-

[Footnote continued on next page]

Nevertheless, the trading threshold imposed by the Rule is significantly more restrictive than the pre-2003 threshold because it now includes trading in swaps. *See* A-1019-20 (Vanguard Comment).

Under the Rule's marketing threshold, a person must represent that the investment company will not market its fund as a commodity pool or as a means to trade in commodity futures, options, or swaps. 77 Fed. Reg. at 11,283. Aside from the inclusion of swaps, this is essentially identical to the pre-2003 marketing threshold. In the explanation accompanying the Rule, however, the Commission identified seven new factors that would guide the application of the test. *Id.* at 11,259. These factors were not identified in the initial rule proposal and therefore were not subject to public notice and comment.[3]

[Footnote continued from previous page]

lic comment. At oral argument, the Commission represented that the test "exempts registered investment companies from the requirement to register unless their commodity derivative investments place at risk more than 100 percent of the total value of the fund in question," but afterwards filed a "clarification" that this "is not necessarily true in all cases," "depending on the terms of the contract." A-119.

[3] In the same rulemaking, the Commission imposed burdensome new reporting requirements on registered CPOs by amending Section 4.27 of its regulations. *See* 77 Fed. Reg. at 11,285-86, 11,295-96. If this Court were to vacate the amendments to Section 4.5, and thus investment companies were not required to register as CPOs, these reporting requirements would also become inapplicable to investment companies.

1. The Commission's Stated Rationale For Regulating Investment Companies And Commenters' Objections

In the initial notice proposing its rule change, the Commission offered no explanation for its departure from the rationale of its 2003 rulemaking, and provided less than a full sentence of analysis of the costs and benefits associated with the new registration thresholds. The proposal provoked sharp criticisms from dozens of rulemaking commenters.

The Commission adopted the Rule on February 24, 2012. The accompanying final rule release implemented numerous regulatory changes in addition to the amendments to Section 4.5, and opened with a "background" section addressing the impetus for these amendments. This "background" section invoked the financial crisis and Dodd-Frank, and stated that the myriad amendments in the rule release would "provide the Commission with . . . information" to address sources of risk to the commodity markets. 77 Fed. Reg. at 11,253.

The Commission did not respond to commenters who argued that the financial crisis could not justify the Rule's amendments to Section 4.5 in particular. As commenters noted, Dodd-Frank did not mandate the amendments, and there is no evidence that *investment companies*' participation in the commodities markets poses any risk to the integrity of the markets. *See*, *e.g.*, A-969-70 (ICI Comment). Commenters also pointed out that, with respect to investment companies, the "reliable information" the Commission sought could be obtained by other means, in-

cluding publicly available disclosures already made by investment companies to the SEC. *See*, *e.g.*, A-1115 (Invesco Comment); A-1064 (Dechert Comment). To the extent the Commission required additional information, commenters suggested, it could be obtained through narrow, information-gathering provisions that would not subject investment companies and their advisers to the additional burden of CPO registration. *See*, *e.g.*, A-846 (ICI Roundtable Comment).[4]

Rather than address these comments, the portions of the Commission's rule release discussing the amendments to Section 4.5 relied specifically on "two significant benefits" from registration of investment companies as CPOs:

> The Commission believes that registration with the Commission provides *two significant benefits*. First, registration allows the Commission to ensure that all entities operating collective investment vehicles participating in the derivatives markets meet minimum standards of fitness and competency. Second, registration provides the Commission and members of the public with a clear means of addressing wrongful conduct by individuals and entities participating in the derivatives markets.

[4] Even the Chairman of the CFTC stated that forms filed by investment companies with the SEC would suffice to provide any information that the CFTC supposedly needs to discharge its responsibilities. *See Webcast: Sixth Annual Capital Markets Summit* (Mar. 28, 2012) (pt. 2 at 25:18) (Statement of Comm'r Gensler), *available at* http://www.uschamber.com/webcasts/6th-annual-capital-markets-summit ("Once they're registered we ought to be able to take the forms from the other agency."). Indeed, he appeared to believe that the Rule would operate in this way: "We said, if you do enough business in futures and swaps, yes, you need to register with the CFTC, but we are more than happy to use the forms that you use over at the SEC. . . . They would be dually registered, but we take all the same documents." *Id.* This, however, is not how the Rule works.

77 Fed. Reg. at 11,254 (emphasis added); *see also id.* at 11,277 (identifying the same "two significant interrelated benefits"). Elaborating on the first of these "two significant benefits," the Commission explained that entities registered as CPOs "are held to a high financial standard through periodic account statements, disclosure of risk, [and] audited financial statements." *Id.* at 11,280. The Commission failed to recognize that these "significant benefits" are already provided by existing SEC regulation, and indeed did not consider SEC regulation at all.

The Commission's final rule release also failed to address its 2003 conclusion that registration of investment companies was unnecessary in light of regulation by the SEC. Commenters argued that SEC regulations "obviate the need" to subject investment companies and their advisers "to redundant or inconsistent regulation." A-1021 (Vanguard Comment). They provided a detailed overview of existing SEC regulation and explained at length how those regulations would overlap and conflict with the Commission's regulations of CPOs. *See* A-1001-10 (ICI Comment); A-907-08 (Fidelity Comment). Yet the Commission offered no response, other than to quote statements by the SEC indicating that (like any effective regulator) the SEC is considering ways to improve its existing regulation of investment companies' use of derivatives. *See* 77 Fed. Reg. at 11,255. The Commission made no effort to determine whether its own oversight would complement, or merely duplicate, the SEC regime. Indeed, its discussion of the Section 4.5

amendments did not cite a single SEC regulation, assess the protections afforded by those regulations, or address how SEC regulation related to CFTC regulation of CPOs.

The Commission claimed the Rule was necessitated by "increased derivatives trading activities by entities that have previously been exempted from registration with the Commission." 77 Fed. Reg. at 11,275. Yet the promotion of such "increased derivatives trading"—and the resulting benefit of greater market liquidity—was the very purpose of the 2003 regulation. Commenters warned that reversing the 2003 regulation could lessen liquidity, and criticized the proposal for failing to consider the "potentially adverse consequences that the amendments could have on market liquidity and, by extension, the broader economy." A-946 (CCMC Comment) (emphasis omitted); *see also* A-984 (ICI Comment). Nonetheless, the final rule release did not address the Rule's effect on liquidity in the markets.

Finally, the Commission sought to justify its Rule on the ground that "entities that are offering services substantially identical to those of a registered CPO should be subject to substantially identical regulatory obligations." 77 Fed. Reg. at 11,255. Commenters, however, observed that the Rule would create new asymmetries: Investment companies (and their advisers) that meet the registration thresholds would be subjected to dual regulation, whereas other CPOs would not. And other "otherwise regulated" entities—including insurance companies, banks, trust

companies, and pension plans—would continue to rely on the Section 4.5 exemption without regard to trading or marketing thresholds; investment companies alone could not. *See*, *e.g.*, A-971 (ICI Comment). The Commission offered "no justification for imposing additional burdens on registered investment companies that, ironically, are subject to far more regulation and oversight than are other entities . . . that may continue to rely on Rule 4.5 in its current form." *Id.*

2. The Commission's Analysis Of Costs And Benefits

Section 15(a) of the CEA requires that "[t]he costs and benefits of the proposed [rule] shall be evaluated in light of—(A) considerations of protection of market participants and the public; (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets; (C) considerations of price discovery; (D) considerations of sound risk management practices; and (E) other public interest considerations." 7 U.S.C. § 19(a).

The Commission, in purporting to discharge this responsibility, acknowledged that "significant burdens may arise from the modifications to [Section] 4.5." 77 Fed. Reg. at 11,278; *see also id.* at 11,276 (discussing "additional compliance costs"). Commenters agreed with this assessment and identified broad-ranging costs from the Rule, including the need to reconcile and satisfy disparate regulatory requirements; develop policies and procedures to comply with CFTC regulations in addition to SEC regulations; upgrade systems to produce additional reports; hire

additional compliance personnel; prepare and distribute required disclosure documents and reports; and establish controls necessary to monitor and assure compliance with trading restrictions. *See* A-880-81 (SIFMA Comment); A-974-75 (ICI Comment). Commenters warned that the proposal's costs could include loss of liquidity. *See supra* at 18. And commenters emphasized that the Rule's costs would be exacerbated by conflicts between SEC and CFTC regulations, which would make it impossible for investment companies to comply with both regimes. *See*, *e.g.*, A-1067 (Dechert Comment).

To justify these costs, the Commission relied again on the "two significant benefits" of its Rule: promotion of fitness and competency, and providing a means to address wrongful conduct. 77 Fed. Reg. at 11,277. The Commission briefly mentioned each of the factors set out in section 15(a). The Commission stated that protection of market participants and the public would be advanced because the Rule "allows the Commission to ensure that all entities participating in derivative markets meet a minimum standard of fitness and competency." *Id.* at 11,280. The Commission concluded that the Rule would promote efficiency because it "will result in the registration of more CPOs," which purportedly "will enable the Commission to better oversee their activities in the derivatives markets." *Id.* And the Commission claimed the Rule would support risk management because disclosure

obligations "provid[e] registrants with an additional method of understanding risk inherent in their day-to-day businesses." *Id.*

Commenters, meanwhile, objected that this cost-benefit analysis failed to "acknowledge the many protections shareholders currently benefit from under the [ICA] and other federal securities laws." A-966 (ICI Comment). Given those protections, the Rule would "impose significant costs on registered investment companies," "without providing any clear benefits." A-863 (SIFMA Comment).

Commenters also argued that the Commission's cost-benefit analysis was incomplete because the Commission could not possibly know the full costs of its Rule before concluding ongoing swap-related rulemakings, including rulemakings further defining the term "swap" and setting margin levels for swap transactions. *See*, *e.g.*, A-899 (Institutional Investors Comment); A-944-45 (CCMC Comment). In the final rule release, the Commission did not explain how it could assess the Rule's costs while these rulemakings remained ongoing; it stated only that the compliance date would "provide entities with sufficient time to assess the impact of such rules" *after* the Rule had been promulgated. 77 Fed. Reg. at 11,258. The Commission also admitted that it lacked data necessary to "evaluate the difference in market impact at various threshold levels." *Id.* at 11,278.

The Commission agreed with commenters that overlapping CFTC and SEC regulation would subject investment companies and their advisers to inconsistent

obligations, acknowledging that "there are certain provisions of its compliance regime that conflict with that of the SEC and that it would not be possible to comply with both." 77 Fed. Reg. at 11,272. Instead of addressing these concerns in the instant rulemaking, however, the Commission announced that, "concurrently with the issuance of this rule, the Commission plans to issue a notice of proposed rulemaking detailing its proposed modifications" to "harmonize the compliance obligations that apply to dually registered investment companies." *Id.* at 11,255.

The Commission suspended application of its "recordkeeping, reporting, and disclosure" requirements to investment companies and their advisers pending conclusion of the harmonization proceeding. *See* 77 Fed. Reg. at 11,252. The Commission's rule release nonetheless counted those provisions as among the benefits of the Rule, citing information-gathering benefits purportedly conferred by the suspended reporting obligations. *Id.* at 11,275. And the first of the Commission's "two significant benefits" highlighted "periodic account statements, disclosure of risk, [and] audited financial statements"—all requirements suspended pending harmonization. *Id.* at 11,280.

At the same time, the Commission greatly discounted the costs of these provisions, deferring its obligation under the Paperwork Reduction Act ("PRA") to "estimate . . . the burden that shall result from the collection of information" (44 U.S.C. § 3507(a)(1)(D)(ii)(V)) pending the conclusion of harmonization. *See* 77

Fed. Reg. at 11,272. The Commission claimed instead that it had attempted to "minimize burdens on affected entities" through harmonization. *Id.* at 11,276. The Commission nowhere acknowledged the possibility that harmonization might fail to fully alleviate the conflicts between the two regimes. It also did not explain how it could reliably determine the Rule's "costs" for purposes of the CEA if it was unable to determine its "burdens" under the PRA.

The Commission issued a proposed harmonization rule on the same day as its final Rule. *See* 77 Fed. Reg. 11,345 (Feb. 24, 2012). In the harmonization release, Commissioner Sommers objected that "[t]he proposed [harmonization] rules . . . would not achieve true harmonization." *Id.* at 11,352. And commenters on that proposal pointed out significant conflicts left unaddressed. *See*, *e.g.*, A-703 (ICI Harmonization Comment). For instance, in response to comments pointing out that the CFTC requires certain disclosures affirmatively prohibited by the SEC, the Commission stated that investment companies could seek no-action letters from the SEC "if necessary and appropriate." 77 Fed. Reg. at 11,347 n.26. Commenters objected that this approach "merely defers the resolution of a known problem to another day." A-722 (ICI Harmonization Comment).

After the Rule was adopted, and while this litigation was pending before the district court, *ISDA v. CFTC* invalidated in its entirety the CFTC rulemaking containing the definitions of *bona fide* hedging that were incorporated by reference in

amended Section 4.5. *See* — F. Supp. 2d —, No. 11-cv-2146 RLW, 2012 WL 4466311 (D.D.C. Sept. 28, 2012). The Commission's Division of Swap Dealer and Intermediary Oversight responded by issuing a "no-action letter" indicating its expectation that funds would rely on the terms of the now-vacated definitions of *bona fide* hedging. A-270.

3. Commissioner Sommers's Dissent

Commissioner Sommers dissented from the Commission's final Rule, including the amendments to Section 4.5. *See* 77 Fed. Reg. at 11,343-44. Congress was "aware of the existing exclusions and exemptions for CPOs when it passed Dodd-Frank," she observed, but "did not direct the Commission to narrow their scope." *Id.* at 11,344. Moreover, there is "no evidence to suggest that inadequate regulation of commodity pools was a contributing cause of the [financial] crisis, or that subjecting entities to a dual registration scheme will somehow prevent a similar crisis in the future." *Id.* As for the Commission's cost-benefit analysis, Commissioner Sommers stated: "I do not believe that the benefits articulated within the final rules outweigh the substantial costs to the fund industry," and "[i]t is unlikely, in my view, that the cost-benefit analysis supporting the rules will survive judicial scrutiny if challenged." *Id.*

D. The District Court Proceedings

Appellants filed their complaint on April 17, 2012, and the parties subsequently filed cross-motions for summary judgment. On December 12, the district court granted summary judgment for the Commission. A-15, 108. Appellants timely filed their notice of appeal.

SUMMARY OF ARGUMENT

I. An agency must provide a reasoned explanation for disregarding facts and circumstances that underlay a prior policy. *FCC v. Fox Television Stations, Inc.*, 129 S. Ct. 1800, 1811 (2009). Yet the Commission in this case reversed its 2003 regulation without acknowledging—much less addressing—its rationale. The Commission concluded in 2003 that registration was unnecessary in light of the "otherwise regulated" nature of investment companies. In reversing that decision, however, the Commission undertook no meaningful analysis of the SEC's regime. And notwithstanding the importance of promoting liquidity to the Commission's 2003 rationale, the Commission's rule release failed even to mention that issue, much less respond to commenters' concerns or explain what impact the Commission believes the Rule will have on the liquidity of the commodity markets.

The Commission's failure to address the "otherwise regulated" nature of investment companies also constitutes a failure to satisfy the Commission's obliga-

tion under Section 15(a) of the CEA to conduct a meaningful analysis of costs and benefits. The SEC is subject to an analogous cost-benefit provision, and this Court has twice vacated SEC rulemakings for failure to assess the "baseline" of existing regulation. *Am. Equity*, 613 F.3d at 178; *Bus. Roundtable*, 647 F.3d at 1154. Yet the Commission committed that same error here: It failed to evaluate whether existing SEC regulations obviate the need for—and hence any expected benefit from—the Rule.

The Commission, as a result, claimed specific benefits from its regulation that will not actually be provided. The Commission twice invoked "two significant benefits"—promoting fitness and competency of registered entities (including through disclosure, periodic reporting, and auditing of financial statements), and providing a means to address wrongdoing by market participants. Both "significant benefits" are already provided by existing SEC regulation.

II. The Commission's cost-benefit analysis was inadequate for another reason: The Commission conducted its rulemaking in a manner that made it impossible to meaningfully assess either costs or benefits. Although the Commission suspended application of its "recordkeeping, reporting, and disclosure" provisions to investment companies and their advisers pending a separate rulemaking intended to "harmonize" those provisions with the SEC's regime, the Commission counted the provisions among the Rule's benefits. But at the same time, the Commis-

sion entirely discounted the costs of those provisions in light of the ongoing harmonization proceeding. The Commission thus sought to have it both ways by simultaneously relying on benefits that may never be provided, while disregarding costs that may prove all too real.

The Commission also could not meaningfully assess the Rule's costs because it enacted the Rule before the conclusion of ongoing swap-related rulemakings—including to define the term "swap"—that would significantly affect the number of firms required to register. And, although commenters suggested that the Commission seek additional data to better understand the Rule's costs, the Commission failed to do so.

III. The Commission also offered inadequate justifications for specific aspects of its Rule. It included swaps within the registration threshold on the illogical basis that it did not know how to write the regulation any other way. It failed to offer any meaningful reason for rejecting proposed alternative definitions of *bona fide* hedging. And it adopted a five percent trading threshold on the basis of a prior rulemaking that, in fact, deemed a five percent threshold unduly restrictive.

IV. Finally, the Commission failed to offer adequate notice to the public when it provided less than a page of analysis of costs and benefits in its notice of proposed rulemaking, and when it failed to give any notice at all of a seven-factor test that will guide application of the marketing threshold.

V. For each of these reasons independently, and all of them together, this Court should vacate the Rule. Any contrary approach would subject investment companies and their advisers to the burdens of duplicative regulation—the central harm that the CFTC failed adequately to consider.

STANDING

Appellants are business associations whose members include investment companies and investment company advisers. The Chamber is also itself an investor in investment companies. Because Appellants are "'object[s] of the action'" under review, there is "'little question'" about their standing to challenge the Rule. *Sierra Club v. EPA*, 292 F.3d 895, 900 (D.C. Cir. 2002) (citation omitted).

STANDARD OF REVIEW

This Court does "not accord any particular deference to the decision of the District Court where, as here, the District Court and this court are both reviewing an administrative record." *Gas Appliance Mfrs. Ass'n v. Dep't of Energy*, 998 F.2d 1041, 1045 (D.C. Cir. 1993) (internal quotation marks omitted). Review of the district court's decision is accordingly *de novo*. *Troy Corp. v. Browner*, 120 F.3d 277, 281 (D.C. Cir. 1997).

The Commission's action promulgating the Rule is reviewed under the standard of review articulated in the Administrative Procedure Act ("APA"). This Court "shall hold unlawful and set aside agency action . . . found to be arbitrary,

capricious, an abuse of discretion, or otherwise not in accordance with law [or] in excess of statutory jurisdiction." 5 U.S.C. § 706(2)(A) & (C). The agency's proffered explanation must be sufficient to show that its decision "was the product of reasoned decisionmaking," *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 52 (1983), and must have "respond[ed] to substantial problems raised by commenters," *Bus. Roundtable*, 647 F.3d at 1149. An agency's decision may not be affirmed "on a ground other than that relied upon by the agency" in the rule release. *Manin v. NTSB*, 627 F.3d 1239, 1243 (D.C. Cir. 2011); *see also SEC v. Chenery Corp.*, 318 U.S. 80, 87-88 (1943). And when an agency has relied on alternative grounds to support a regulatory choice and even one of those grounds is deficient, this Court "will ordinarily vacate the [rule] unless [it is] certain that [the agency] would have adopted it even absent the flawed rationale." *Nat'l Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831, 839 (D.C. Cir. 2006).

ARGUMENT

I. The Commission Arbitrarily Reversed Its Prior Rulemaking With No Meaningful Justification.

The Commission in this case disregarded a basic requirement of agency rulemaking: "Reasoned decision making . . . necessarily requires the agency to acknowledge and provide an adequate explanation for its departure from established precedent." *Dillmon v. NTSB*, 588 F.3d 1085, 1089-90 (D.C. Cir. 2009). An agency must provide a "reasoned explanation" for "disregarding facts and cir-

cumstances that underlay" its "prior policy." *Fox*, 129 S. Ct. at 1811. Indeed, "[i]t would be arbitrary or capricious to ignore such matters." *Id.* Yet that is precisely what the Commission did here: It abruptly changed course and failed even to mention—much less provide an explanation for disregarding—its conclusion in 2003 that eliminating the trading and marketing thresholds would confer significant benefits without imposing significant costs.

A. The Rule imposes trading and marketing thresholds identical in most respects to those the Commission eliminated in 2003. It is true that the net notional test is new, but any added flexibility it provides is outweighed by the addition of swaps; because the new regime covers swaps, it is *more* restrictive than the pre-2003 regime. Throughout this litigation, the Commission has attempted, without success, to downplay these similarities. It initially represented that the pre-2003 regulation contained no *bona fide* hedging exemption, but then acknowledged in an "erratum" that this was false. *See* D.E. 23. And while the Commission at oral argument stated that the net notional test targets firms with significant exposure to the commodity markets, it later submitted a "clarification" admitting that the effect of the test depends on "the terms of the contract" for the underlying instrument. A-119. In substance, the Rule constitutes a complete reversal; whereas the 2003 amendments eliminated *any* registration requirement, the Rule re-imposes trading and marketing thresholds for investment companies and their advisers.

Nonetheless, the Commission's 2003 analysis of costs and benefits goes *unmentioned* in the final rule release. There is not a single instance where the Commission acknowledges its 2003 rationale and explains why it no longer finds that rationale persuasive. The Commission thus "crossed the line from the tolerably terse to the intolerably mute." *Williams Gas Processing-Gulf Coast Co. v. FERC*, 475 F.3d 319, 329 (D.C. Cir. 2006) (internal quotation marks omitted).

This abdication is particularly striking with respect to the issue of liquidity. The final rule release seeks to justify the Rule in part on the ground that investment companies are increasingly participating in the commodity markets. 77 Fed. Reg. at 11,275. Yet this is the very result the Commission sought to achieve in 2003: The Commission concluded that the 2003 amendments would promote liquidity *because* investment companies would increasingly participate in the commodity markets. *See* 2003 Adopting Release at 47,223. The Commission's shift—from regarding this participation as a benefit, to regarding it as a problem—required explanation. The Commission provided none. Indeed, the word "liquidity" does not appear in the final rule release. To this day, we simply do not know the Commission's position on these issues: Will liquidity decrease? How does that affect the Rule's costs and benefits? A matter of such importance to the Commission's 2003 rationale, and to the Rule's overall costs and benefits, should not have been left unaddressed. *See*, *e.g.*, *Int'l Ladies' Garment Union v. Donovan*, 722 F.2d 795,

825 (D.C. Cir. 1983) (vacating amended regulation based on failure to address "concerns" motivating earlier regulation).

Even putting aside the 2003 rulemaking, the Commission's silence with respect to liquidity constitutes an impermissible failure to consider "an important aspect of the problem." *Owner-Operator Indep. Drivers Ass'n v. FMCSA*, 494 F.3d 188, 205 (D.C. Cir. 2007) (internal quotation marks omitted). That issue was squarely raised by commenters. *See* A-946 (CCMC Comment); A-1067 (Dechert Comment). And the Commission was also bound by the CEA to "consider" and "evaluat[e]" this and other issues of market "efficiency" and "competitiveness." 7 U.S.C. § 19(a). In dereliction of these obligations, the CFTC remained silent.

Other aspects of the Commission's 2003 rationale went similarly unmentioned. In 2003, the Commission found—in light of the "otherwise regulated" nature of investment companies—that there would be "no decrease in the protection of market participants and the public" as a result of eliminating the registration thresholds, because the amendments adjust the Commission's regulations "to be consistent with existing requirements under the federal securities laws and the SEC's rules." 2003 Adopting Release at 47,230. Notwithstanding this prior conclusion, the Commission failed to meaningfully address the adequacy of existing regulation—the relevant portions of the rule release do not cite or discuss a *single*

SEC regulation—and instead claimed benefits already provided by the SEC. *See infra* at 39-50.

B. Throughout this litigation, the Commission has attempted to paper over these gaps in its analysis through invocation of "changed circumstances" since 2003, particularly the financial crisis and Dodd-Frank. Relying on the "background" section of the rule release—which addresses the impetus for *all* the various provisions promulgated in the release—the Commission has attempted to place those circumstances at the center of its rationale, despite its inattention to them in the portions of the rule release addressing the amendments to Section 4.5 *specifically*. The Commission has therefore suggested—and the district court agreed—that the Rule is justified by a new regulatory "philosophy" ushered in by the crisis and Dodd-Frank. D.E. 15 at 25; *see also* A-64-65. But a purported pro-regulatory "philosophy" does not suspend the APA or immunize all new regulations that an agency adopts, any more than a de-regulatory "philosophy" would justify all de-regulatory measures. *See State Farm*, 463 U.S. at 41. The Commission was obligated to explain why the financial crisis and Dodd-Frank justified its specific amendments to Section 4.5. Yet it did not.

The Commission never suggested that investment companies were somehow responsible for the financial crisis. Indeed, the Commission acknowledged below that it "has not attributed the financial crisis specifically to" investment companies.

D.E. 15, at 24 n.10. The district court attempted to cast doubt on this concession by citing legislative history (not invoked by the agency) regarding investment *banks*—an error the Commission sought to correct in an "Erratum" that asked the district court to change the reference from "investment banks" to "investment companies." *See* A-12, 63. The district court implemented the Commission's suggestion, *see* A-11, but changing a word does not correct the error—and evident misunderstanding—underlying the court's reasoning: Investment companies are not the same as investment banks, and extra-record legislative history regarding investment *banks* cannot properly be used to retroactively justify regulation of investment *companies*.[5]

Moreover, notwithstanding its repeated invocations of Dodd-Frank, the Commission has never confronted this telling fact: Dodd-Frank required the issuance of hundreds of rules, but not the amendments at issue here. Congress amended the statutory definition of "CPO" to include entities that engage in swap transac-

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[5] In a petition for rulemaking, the NFA identified three investment companies that the NFA believed were operating as "de facto commodity pool[s]" while also claiming exclusion under Section 4.5. *See* 76 Fed. Reg. at 7,983. The Commission, however, has never sought to demonstrate that those entities somehow pose a threat to the commodity markets, or that they are not adequately regulated already. Nor has the Commission ever explained how the identification of three such entities could possibly justify a Rule that will sweep much more broadly—or why, if those entities provided the impetus for the Rule, the Commission could not have adopted a narrower alternative, as commenters suggested. *See* A-982-86 (ICI Comment).

tions, but it *preserved* the Commission's authority to exclude entities from that definition. *See* Pub. L. No. 111-203, § 721(a)(6), 124 Stat. 1376, 1659-60 (2010). And while Congress singled out particular segments of the financial industry for additional regulation—for instance, it imposed new requirements, including a variety of disclosure and reporting obligations, on advisers to so-called "private funds," *id.* § 406, 124 Stat. at 1574—no such requirements were added for investment companies.

The district court (following the Commission's lead) attempted in its opinion to bridge the gap between the "changed circumstances" and the Rule by suggesting the Rule was necessary to fill gaps in the information available to the agency in the wake of the financial crisis. *See* A-58. But there is no guarantee the information-gathering benefits of the Rule will materialize, as the required disclosures are contingent on the still-ongoing "harmonization" proceeding. *See infra* at 51-56. Additionally, the Commission in the final rule release failed to address comments suggesting information could be obtained by other means, including publicly available disclosures *already* made to the SEC, as well as extensive swaps-related disclosures required by Dodd-Frank and implementing regulations that govern *all* market participants, including investment companies. *See*, *e.g.*, A-1115 (Invesco

Comment); A-906 (Fidelity Comment).[6] If those disclosures were inadequate, commenters suggested, additional reporting could be required without subjecting investment companies and their advisers to additional burdens associated with CPO registration; the Commission failed even to consider that less restrictive alternative. *See*, *e.g.*, A-846 (ICI Roundtable Comment). Reliance on information-gathering is, therefore, simply *another* problem with the rationale advanced for the Rule. *See Rio Grande Pipeline Co. v. FERC*, 178 F.3d 533, 543 (D.C. Cir. 1999) (reversing agency for failure to consider less restrictive alternative). Remarkably, although Appellants pointed out this failure to the district court, *see* D.E. 26 at 36, the court (like the CFTC) did not address it.

The district court sought instead to bolster the purported link between the Rule and the financial crisis by extensively citing Dodd-Frank's legislative history. That history was not included in the rule release, or even the Commission's briefs, and cannot now be used to justify the Rule. *See Chenery*, 318 U.S. at 87. Even more significantly, the legislative history provides the rationale only for the regulations *actually required* by Dodd-Frank. When the legislative history discusses the importance of providing "'tools to monitor and discourage potentially risky activi-

[6] On the SEC's Form N-1A, an investment company must disclose the types of instruments in which it invests or will invest, including derivatives. And, as part of their financial statements, investment companies must provide a list of all open derivatives positions on a contract-by-contract basis. *See* 17 C.F.R. § 210.12-13.

ties,'" A-92 (quoting S. Rep. No. 111-176, at 34 (2010)), for example, it is describing the purpose behind mandated rulemakings such as swaps reporting and recordkeeping requirements recently promulgated by the CFTC. *See* 77 Fed. Reg. 2,136 (Jan. 13, 2012); 77 Fed. Reg. 1,182 (Jan. 9, 2012). The district court articulated no meaningful connection between this legislative history and the Rule. If anything, the fact that Congress required the CFTC to promulgate *other* rules to collect information on swaps strongly suggests that it did not envision a need to gather data on swaps through the Rule at issue here—or at the very least that the Commission should have considered those rules in evaluating the benefits of the Rule.

In any event, *post hoc* reliance on the financial crisis and Dodd-Frank cannot substitute for the Commission's obligation to address the facts and circumstances underlying its 2003 rulemaking—including the Rule's effect on the issue of liquidity. Even if the Commission could—in theory—permissibly determine that the need for information in the wake of the financial crisis justified departure from that prior rationale (despite the fact that the Rule will not require disclosure of *any* information, pending harmonization), the Commission did not set forth that reasoning or explain its departure from the considerations it previously had found compelling.

Ultimately, whatever the prevailing regulatory "philosophy" may be, the Commission has an obligation to explain its departure from the reasoning underly-

ing its 2003 amendments. After all, "change must be reached through reasoned decision." *Wheaton Van Lines, Inc. v. ICC*, 671 F.2d 520, 527 (D.C. Cir. 1982). The Commission's failure to address its prior conclusions was arbitrary and capricious, violated the APA, and requires vacatur of the Rule.

II. The Commission's Assessment Of Costs And Benefits Violated Both The Administrative Procedure Act And The Commodity Exchange Act.

Section 15(a) of the CEA provides that the Commission must "consider the costs and benefits" of its proposed rules, which "shall be evaluated" based on "protection of market participants and the public," "efficiency, competitiveness, and financial integrity of futures markets," "price discovery," and "sound risk management practices," among other things. 7 U.S.C. § 19(a). This directive is similar to the SEC's obligation to "consider . . . whether [its rules] will promote efficiency, competition, and capital formation." 15 U.S.C. § 78c(f); *see also id.* §§ 77b(b), 80a-2(c).[7] The SEC's failure to fulfill that requirement has resulted in a series of recent decisions by this Court invalidating SEC rules. *See Bus. Roundtable*, 647 F.3d 1144; *Am. Equity*, 613 F.3d 166; *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005). In this case, the CFTC likewise failed to comply with its

[7] If anything, the obligation placed on the CFTC is even more stringent than the obligation placed on the SEC. The SEC is directed to "consider" costs and benefits, whereas the CFTC must *both* "consider" and "evaluat[e]." To "evaluate" is "to determine or fix the value of" or to "determine the significance, worth, or condition of" a thing, usually "by careful appraisal and study." *Merriam-Webster Collegiate Dictionary* 401 (10th ed. 1993).

statutory obligation to conduct a meaningful cost-benefit analysis—and therefore acted arbitrarily and capriciously, and not in accordance with law—in at least three separate respects.

A. Because The Commission Failed To Assess Existing Regulation, The Commission Could Not Know Whether Its Rule Afforded Any Benefits.

When evaluating the benefits of a rule, a necessary first step is to identify some problem not addressed by existing regulation. Thus, for instance, this Court in *Business Roundtable* vacated an SEC rule directed to investment companies because the agency "failed adequately to address whether the regulatory requirements of the ICA reduce the need for, and hence the benefit to be had from," further regulation. 647 F.3d at 1154. And in *American Equity*, this Court vacated a rule because the SEC failed to examine existing regulations to "determine whether, under the existing regime, sufficient protections existed." 613 F.3d at 179. In both cases, the agency failed to explain why, given rules already on the books, there was need for added regulation. Requiring such an explanation makes good sense: If a rule is unnecessary, it is difficult to say how the rule can yield any benefit, or how its benefits can justify its costs. Yet precisely this error pervades the rulemaking here.

The Rule layers CFTC and NFA regulation on top of existing regulation by the SEC and FINRA, subjecting investment companies to four separate regulatory masters and giving rise to a significant risk of "duplicative regulation." *Am. Equi-*

ty, 613 F.3d at 177; *see also* Exec. Order No. 13,563, 76 Fed. Reg. 3,821, 3,822 (Jan. 18, 2011) (noting potentially significant costs associated with "redundant, inconsistent, or overlapping" regulation by multiple agencies). The Commission itself acknowledged that these regulatory regimes serve the same goals, stating that "the Commission and the SEC share many of the same regulatory objectives." 77 Fed. Reg. at 11,278. But the Commission failed to compare the protections of these regimes. The final rule release does not identify which SEC and FINRA regulations affect investment companies and their service providers, nor does it determine which CFTC and NFA regulations overlap with those existing requirements. The portions of the final rule release discussing Section 4.5 *do not even cite a single SEC regulation*, much less assess whether existing regulations would satisfy the regulatory aims of the CFTC.

The Commission failed to undertake this analysis notwithstanding significant comments in the record that *did*. Commenters concluded that overlapping regulation would be "unnecessary," A-1014 (Janus Comment), "duplicative," A-975 (ICI Comment), and "redundant," A-1018 (Vanguard Comment), not to mention "burdensome and costly, as well as potentially confusing to investors," A-991 (ICI Comment). *See generally* A-1139-41 (SIFMA Comment) (extensive comparison of SEC and CFTC regulations). The Commission's lack of attention to SEC protections therefore constituted an impermissible failure to respond to significant

comments in the record. *See La. Fed. Land Bank Ass'n v. FCA*, 336 F.3d 1075, 1080 (D.C. Cir. 2003).

This failure led the Commission to draw specific conclusions regarding the cost-benefit factors enumerated in Section 15(a) that could not be supported by its analysis. Indeed, the Commission relied on benefits that *are*, *in fact*, already provided by the SEC. The Commission determined that its Rule will protect market participants and the public by promoting transparency through "periodic account statements, disclosure of risk, audited financial statements, and other measures designed to provide transparency to investors." 77 Fed. Reg. at 11,280. The Commission determined that the Rule will advance the efficiency, competitiveness, and financial integrity of the futures markets because it "will result in the registration of more CPOs," which purportedly "will enable the Commission to better oversee their activities in the derivatives markets." *Id.* And the Commission determined that sound risk management will be advanced because required disclosures "provid[e] registrants with an additional method of understanding the risk inherent in their day-to-day businesses." *Id.* Yet *each* of these conclusions is baseless without an assessment of existing regulations, and the extent to which those regulations *already* provide the benefit of transparency (including through periodic reporting, risk disclosure, and audited financial statements), already facilitate regulatory oversight of investment companies and their advisers (including their activi-

ties in the derivatives markets), and already provide regulated entities with means to assess risks inherent in their businesses.

The facts of this case are directly analogous to *American Equity*—and, if anything, *more* compelling. In *American Equity*, the SEC attempted to subject fixed indexed annuities to regulation as securities, notwithstanding existing state regulation of those same entities. In its rule release, the SEC acknowledged "recent and ongoing efforts by state insurance regulators" and mentioned particularly relevant state laws. *See* 74 Fed. Reg. 3,138, 3,148 (Jan. 16, 2009). Yet this Court deemed that analysis inadequate: The SEC had failed to "assess the baseline" of existing regulation, and its analysis was "incomplete because it fails to determine whether, under the existing regime, sufficient protections existed to enable investors to make informed investment decisions." 613 F.3d at 178, 179; *see also id.* ("The SEC's failure to analyze the efficiency of the existing state law regime renders arbitrary and capricious the SEC's judgment that applying federal securities law would increase efficiency."). If that was true of the rule release in *American Equity*, it is even clearer on the facts of this case—where the existing SEC regime received *no* meaningful analysis.

This case is likewise on all fours with the portion of *Business Roundtable* addressing the application of the SEC's "proxy-access" rule to investment companies. There, investment companies challenged the rule on the ground that the SEC

failed to assess satisfactorily whether regulatory requirements under the ICA reduced the need for the measure. This Court agreed: The SEC "failed adequately to address whether the regulatory requirements of the ICA reduce the need for, and hence the benefit to be had from," the rule. 647 F.3d 1154. The CFTC committed the same error here.

The Commission, in its final rule release, deemed such an analysis unnecessary in light of the CFTC's "Congressional mandate" to regulate the "commodity and derivatives markets." 77 Fed. Reg. at 11,278. But the SEC made a similar claim in *Business Roundtable*, asserting that its regulation was justified because it had a "mandate from Congress" to "actively overse[e] the development of the proxy process." 74 Fed. Reg. 29,024, 29,025 (Jun. 18, 2009). And, in *American Equity*, the SEC similarly argued that state regulation "could not substitute" for regulation by the SEC, as Congress had given the SEC authority to regulate securities. 613 F.3d at 178 (internal quotation marks omitted). This Court, however, concluded that the SEC's reliance on its statutory authority to override the obligation to perform a meaningful cost-benefit analysis was "misplaced." *Id.* Similarly here, the Commission cannot evade its obligation to assess the baseline of existing regulation by relying on its statutory authority to regulate derivatives.

The Commission, in this litigation, has attempted to spin this *ipse dixit* reference to its regulatory jurisdiction into a meaningful distinction: The SEC, the

Commission has argued, regulates securities, whereas the CFTC regulates derivatives. This supposed distinction, however, fails to account for the fact that the SEC regulates investment companies as investment vehicles, and not simply as participants in the securities markets; for this reason, SEC regulation of investment companies extends to those entities' holdings in derivatives. Among other things, the SEC limits investment companies' ability to create risk through leverage, including through use of derivatives;[8] subjects investment companies to a unique requirement of board oversight, and tasks board members with ensuring that the fund's investment manager has the capacity to measure and monitor the fund's risk exposure from use of derivatives;[9] and requires public disclosure that extends to investments in derivatives.[10] Investment companies' use of derivatives is also subject to—

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[8] *See* 15 U.S.C. § 80a-18; A-908 (Fidelity Comment) (citing Dreyfus Letter, and Securities Trading Practices of Registered Investment Companies, 44 Fed. Reg. 25,128 (Apr. 27, 1979)).

[9] *See* 15 U.S.C. §§ 80a-10(a), 80a-2(a)(19); *see also, e.g.,* A-863 (SIFMA Comment); ABA Rpt. at 45. The board's general oversight includes the "particular responsibility to ask questions concerning why and how the fund uses futures and other derivatives instruments, the risks of using such instruments, and the effectiveness of internal controls designed to monitor risk and assure compliance with investment guidelines regarding the use of such instruments." Custody of Investment Company Assets With Futures Commission Merchants and Commodity Clearing Organizations, 61 Fed. Reg. 66,207, 66,209 (Dec. 17, 1996).

[10] *See*, *e.g.*, Items 4(a), 9(b), and 16(b) of Form N-1A; 17 C.F.R. § 210.12-13. The SEC has, in fact, emphasized to the investment company industry "the importance of specifying derivatives disclosure in share-holder communications." A-1071 (Dechert Comment) (citing Miller Letter).

among other things—prohibitions on affiliated transactions, requirements regarding portfolio concentration, and restrictions on counterparty credit exposure. *See supra* at 9-10. The Commission nowhere assessed the import of these requirements for the purported benefits of the Rule.

Recent actions by the SEC with respect to investment companies' participation in the derivatives markets confirm that it is actively engaged in providing regulatory oversight. The SEC has issued a Concept Release emphasizing that a "fund that invests in derivatives must take into consideration various provisions of the [ICA] and [SEC] rules under the Act," including provisions "governing diversification, concentration, investing in certain types of securities-related issuers, valuation, and accounting and financial statement reporting," as well as "applicable disclosure provisions." Use of Derivatives by Investment Companies Under the Investment Company Act of 1940, 76 Fed. Reg. 55,237, 55,238-39 (Sept. 7, 2011) ("Concept Release"). And, while the SEC has sought public comment regarding ways in which its regulation of derivatives might be enhanced—a query made periodically by any effective regulator—the Concept Release also reports the conclusion of an American Bar Association report that the SEC's "'basic framework'" for addressing the leverage-related risk of derivatives "'has worked very well.'" *Id.* at 55,245, 55,253 (quoting ABA Rpt. at 16).

The Commission disregarded these aspects of the SEC's Concept Release and instead focused on its discussion of ways the SEC regime might be improved. *See* 77 Fed. Reg. at 11,255. The SEC observed, for example, that its regulations had evolved on a "case-by-case basis" and that the agency going forward intended to "take a more comprehensive and systematic approach." Concept Release at 55,239, *quoted in* 77 Fed. Reg. at 11,255. But the fact that the SEC might seek to improve its regulations hardly establishes that subjecting investment companies and their advisers to two additional regulators will yield tangible benefits. The Commission failed to undertake any analysis to determine whether its own regulations would remedy any shortcomings identified in the Concept Release, let alone whether the benefit of addressing issues *already being considered* by the SEC would outweigh the Rule's costs.

Perhaps realizing that *American Equity* and *Business Roundtable* could not meaningfully be distinguished, the district court, in its decision upholding the Rule, sought to minimize their significance. It began its discussion of a financial regulatory agency's cost-benefit obligations with no reference to those decisions—less apposite cases were used to frame the legal standard, *see* A-52-53—and, even more remarkably, concluded its analysis with a lengthy footnote citing academic commentary critical of *this* Court's cost-benefit jurisprudence, *see* A-106 n.35. The district court also suggested that the standard of review articulated in this

Court's decisions is somehow lessened where an agency "is fulfilling expanded regulatory responsibilities mandated under Dodd-Frank." A-59. Dodd-Frank contained hundreds of provisions requiring rulemaking of various sorts, but nothing in the statute mandated *this* Rule. *See supra* at 34-35. In any event, Congress is presumed to have been aware of this Court's decisions requiring an agency subject to a cost-benefit provision like the one that governs the CFTC to assess the "baseline" of benefits under existing regulations, yet did nothing to overturn those decisions. *Am. Equity*, 613 F.3d at 178; *see also Chamber of Commerce*, 412 F.3d at 143. In fact, Dodd-Frank prohibited the SEC from re-adopting the very rule invalidated in *American Equity*. Pub. L. No. 111-203, § 989J, 124 Stat. at 1949.

Ultimately, the Commission's failure to assess the baseline of existing regulation constitutes a violation of *both* the APA and the cost-benefit provision of the CEA. In order to "articulate a satisfactory explanation for its action," *State Farm*, 463 U.S. at 43, an agency must ordinarily explain why its rule is necessary, or, put differently, what problem the rule is meant to address. *See*, *e.g.*, *Nat'l Fuel Gas Supply*, 468 F.3d at 841 (vacating agency action where there was "no evidence of a real problem"). But without assessing existing regulation, the Commission could not possibly know whether there was some problem left unaddressed, or whether its regulation would instead be duplicative. The Commission failed to address the

"probability the rule will be of no net benefit as applied to investment companies." *Bus. Roundtable*, 647 F.3d at 1155. This fundamental error requires vacatur.

B. The Commission Relied On Specific Purported Benefits Not Supported By Its Analysis.

In the course of its analysis, the Commission repeatedly invoked specific benefits of its Rule, without determining whether those benefits were already provided by existing regulation. The Commission's failure even to inquire into these issues would be sufficient to require vacatur of the Rule. Upon even minimal examination, however, it is plain that these benefits *in fact* will not be provided.

In the final rule release, the Commission repeatedly invoked "two significant benefits" of its Rule. It stated:

> The Commission believes that registration with the Commission provides *two significant benefits*. First, registration allows the Commission to ensure that all entities operating collective investment vehicles participating in the derivatives markets meet minimum standards of fitness and competency. Second, registration provides the Commission and members of the public with a clear means of addressing wrongful conduct by individuals and entities participating in the derivatives markets.

77 Fed. Reg. at 11,254 (emphasis added); *see also id.* at 11,277 (identifying the same "two significant interrelated benefits"). Yet, despite the significance of these purported benefits to the Commission's analysis, the Commission nowhere assessed whether these benefits are already provided.

The first of these benefits—to ensure minimum standards of fitness and competency—is addressed by existing SEC and FINRA regulation. When the

Commission specified how the Rule would achieve this goal, it explained that registration as CPOs would ensure that investment companies and their advisers "are held to a high financial standard through periodic account statements, disclosure of risk, [and] audited financial statements." 77 Fed. Reg. at 11,280. But these are central features of the existing SEC regime: The SEC requires investment companies to file account statements annually and semi-annually (15 U.S.C. § 80a-29(a), (b)), requires investment companies to make extensive risk disclosures in their fund prospectuses (Forms N-1A and N-2), and mandates auditing of financial statements (15 U.S.C. § 80a-29(g)). The Commission could not properly rely on these purported benefits, when the very same benefits are already provided by other regulation.

The Commission also indicated that minimum standards of fitness and competency would be advanced by subjecting affiliated persons of investment companies to qualifications testing by the NFA. However, FINRA already subjects employees of broker-dealers that distribute investment company shares to such testing. And existing CFTC regulations recognize the value of SEC and FINRA standards: The CFTC's regulations exempt from regulation and qualifications testing by the NFA most persons who are associated with broker-dealers that distribute investment company shares and who already are subject to qualifications testing by

FINRA. *See* 17 C.F.R. § 3.12(h)(1)(ii). The Commission nowhere addressed the significance of FINRA's testing regime to the Rule's purported benefits.

The Commission's second "significant" benefit—that the Commission "has direct authority to take punitive and/or remedial action against registered entities"—is similarly flawed. The SEC's broad enforcement powers include authority to conduct investigations and issue subpoenas, 15 U.S.C. §§ 80a-41, 80b-9, and to inspect the books and records of an investment company or its adviser "at any time," *id.* §§ 80a-30(b), 80b-4. The SEC may initiate administrative proceedings, where available sanctions include monetary penalties, disgorgement, cease and desist orders, censure, and revocation of registration. *See id.* §§ 80a-9, 80b-3. And the SEC may pursue civil remedies in judicial proceedings. *See id.* §§ 80a-41, 80a-48, 80b-14. Congress enhanced these enforcement powers in Dodd-Frank. *See* Pub. L. No. 111-203, §§ 921-929U, 124 Stat. 1841-68. Moreover, FINRA has additional authority to discipline broker-dealers who distribute investment company shares, including through suspension and disbarment. Because existing regulations provide ample means to address misconduct by investment companies and their service providers, the CFTC erred in relying on its parallel enforcement authority as a "significant" benefit of the Rule.

Although Appellants repeatedly emphasized the illusory nature of the "two significant benefits" in their briefs in the district court and at oral argument—

where the crucial passages of the Commission's rule release were displayed as a demonstrative exhibit—the district court's opinion did not address this argument at all. Yet the Commission's failure to assess whether these purported benefits are already provided by the SEC's regulatory regime is fatal to the rulemaking.

C. The Commission Made It Impossible To Fully Determine The Costs And Benefits Of Its Rule, As Required By Law.

Finally, the Commission's cost-benefit analysis was inadequate because the Commission conducted its rulemaking in a manner that made it impossible to fully determine costs and benefits before promulgation. The Commission thus failed to "apprise itself—and hence the public and the Congress—of the economic consequences of [its] proposed regulation." *Chamber of Commerce*, 412 F.3d at 144.

1. The Commission deprived itself of the ability to evaluate costs and benefits by adopting a Rule that it admitted would create conflicts and overlap with SEC regulations, and by failing to determine, prior to finalization of the Rule, whether and how those problems could be resolved. Faced with this self-manufactured uncertainty, the Commission claimed benefits that may not ultimately be provided, even as it relied on this same uncertainty to discount potential future costs. The Commission thus systematically understated the Rule's costs, while simultaneously overstating its benefits.

The Commission agreed with commenters that "there are certain provisions of its compliance regime that conflict with that of the SEC and that it would not be

possible to comply with both." 77 Fed. Reg. at 11,272. Commenters who pointed out these conflicts urged the Commission either to refrain from regulation, or to re-propose *this Rule* with measures designed to resolve the conflicts. *See*, *e.g.*, A-973-74 (ICI Comment). Instead, the Commission determined to proceed with its rulemaking without addressing the conflicts, but to suspend application of "record-keeping, reporting, and disclosure requirements" to investment companies and their advisers pending a separate "harmonization" rulemaking. 77 Fed. Reg. at 11,252.

Despite having suspended application of its "recordkeeping, reporting, and disclosure" regulations, the Commission on numerous occasions claimed benefits from those requirements. For instance, in explaining the first of its "two significant benefits," the Commission relied on "periodic account statements, disclosure of risk, [and] audited financial statements," 77 Fed. Reg. at 11,254, 11,280—all of which are aspects of the CPO regime suspended pending harmonization. Likewise, the information-gathering provisions of the CPO regime (which have assumed out-sized importance in the Commission's defense to this litigation) have been sus-

pended.[11] At this time, we do not know how many of those aspects of the CPO regime will be applied to investment companies and their advisers.

At the same time that it relied on these uncertain benefits, the Commission discounted the potential costs of the suspended requirements. The Commission nowhere considered the potential for conflict between SEC and CFTC regulations as among the Rule's costs; instead, the Commission congratulated itself on having undertaken "cost-mitigation measures," including the not-yet-complete "efforts to harmonize its compliance requirements." 77 Fed. Reg. at 11,276. The Commission apparently assumed—without any justification—that harmonization would be entirely successful.

The Commission also effectively conceded that it could not meaningfully assess the Rule's costs prior to harmonization. The PRA requires agencies to publish an estimate of the burdens associated with a new rule. *See* 44 U.S.C. § 3507.[12] The PRA thus specifically addresses one component of the cost-benefit analysis

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[11] At oral argument before the district court, the Commission represented that some information-gathering requirements (specifically, those imposed by the Rule's amendments to Section 4.27, *see supra* at 14 n.3) would become effective immediately upon registration. *See* A-168. However, the Commission subsequently informed the district court that it had been mistaken, and that *all* information-gathering requirements are suspended pending harmonization. *See* A-114.

[12] As the House Report accompanying the PRA explained, Congress instituted this requirement because excessive information collection can impose "significant costs on the economy." H.R. Rep. No. 104-37, at 5 (1995); *see also* 44 U.S.C. § 3501(1).

required by the CEA—burdens associated with information collection. The Commission, however, announced that it would not conduct the analysis mandated by the PRA in the rule release, and that it would instead conduct the analysis only after harmonization. 77 Fed. Reg. at 11,272. The Commission nowhere explained how it could calculate the *costs* of the Rule, as required by the CEA, if it could not satisfy its obligation under the PRA to calculate the *burdens*.

This failure to assess the Rule's costs renders the Commission's analysis incomplete, and also is flatly inconsistent with the Commission's determination to rely on benefits that remain contingent on harmonization—an inconsistency neatly illustrated by the Commission's treatment of the disclosure obligations that apply to CPOs. The Commission counted those obligations as benefits of the Rule. 77 Fed. Reg. at 11,280. But, as commenters pointed out, CPO disclosure requirements conflict with SEC disclosure requirements applicable to investment companies: For instance, certain disclosures regarding past performance are *required* by the CFTC, but are *prohibited* by the SEC as potentially misleading. *See* A-1003 (ICI Comment). Harmonization could yield only two possible results: *First*, the Commission might eliminate conflicting disclosure requirements, meaning the benefit relied on by the Commission will never materialize; or, *second*, the Commission might retain the requirements, thus retaining the claimed benefit but im-

posing a cost that was never factored into the analysis. Either way, the Commission overstated the Rule's benefits and understated its costs.[13]

The district court rejected Appellants' challenge to this aspect of the Commission's rulemaking on the ground that "compliance obligations" suspended pending harmonization are "not yet fit for review." A-78. The district court stated that, "[w]hile these compliance obligations are indisputably related to, and 'flow from,' the registration requirement," "such compliance" is nonetheless "separate from and peripheral to the registration requirement." *Id.* But the district court never explained how, if the potential *costs* of the provisions subject to harmonization are "peripheral to" the Rule, the Commission could permissibly count the application of those provisions as among the Rule's *benefits*.

The district court's reliance on considerations of ripeness to reject this aspect of the challenge is misplaced. Appellants are not challenging the compliance obligations themselves, but rather are challenging the Commission's determination to impose a registration requirement while simultaneously depriving itself of the ability to know what costs and benefits would "flow from" that requirement. That

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[13] If the Commission's harmonization proposal is any guide, these undercounted costs will be significant. Commissioner Sommers objected that the proposal "would not achieve true harmonization." 77 Fed. Reg. at 11,352. And commenters on the harmonization rulemaking have identified numerous conflicts left unaddressed. *See* A-721-46 (ICI Harmonization Comment).

claim is undoubtedly ripe for judicial consideration.[14] Regardless of what compliance obligations are ultimately imposed, the Commission's approach in the instant rulemaking was arbitrary and capricious, and did not comport with the cost-benefit provision of the CEA.

The district court also observed that rulemaking may sometimes proceed "in stages." A-79. Appellants do not deny that agencies may sometimes address a problem in pieces—for instance, by first regulating one contributing factor to a problem, and later regulating a second. However, an agency (particularly an agency subject to a cost-benefit provision) cannot use a multi-step approach to entirely discount the potential costs of its actions, while simultaneously claiming benefits that are contingent on that same future agency action. That is what the Commission did here.

[14] This Court's test for ripeness looks to the "fitness of the issues for judicial determination" and the "hardship to the parties of withholding court consideration." *La. Pub. Serv. Comm'n v. FERC*, 522 F.3d 378, 397 (D.C. Cir. 2008) (per curiam) (internal quotation marks omitted). Under the first factor, the agency "[h]as conclusively resolved" the question of whether to impose a registration requirement. *Id.* at 398. Under the second factor, although an independent showing of hardship is not required to establish ripeness, *Rio Grande Pipeline Co.*, 178 F.3d at 540-41, postponing consideration of the registration requirement until the conclusion of harmonization would place Appellants in an untenable position. Appellants would needlessly be required to re-litigate these issues in district court; and, meanwhile, they would be required to comply with the registration requirement—and subjected to CFTC and NFA oversight—while simultaneously being denied an opportunity to challenge that requirement pending conclusion of harmonization.

2. The Commission also made it impossible to meaningfully assess the costs of its Rule in another way: It included swaps within the trading threshold even though key swap-related regulations—including the very definition of the term—had yet to be finalized. The Commission had not adopted a final definition of the term swap or established margin requirements for uncleared swap transactions, and the Department of Treasury had not issued a final determination on whether it would exempt certain foreign exchange swaps and forwards from the definition. Because the trading threshold requires registration where the "initial margin and premiums required to establish" positions in "swaps" exceeds five percent, or when trading in "swaps" triggers the alternative net notional test, the ultimate determination of all these issues had the potential to significantly affect the number of firms required to register. And, without knowing how many firms would be required to register, it was impossible to meaningfully assess the Rule's costs.

When commenters raised this concern, the Commission responded that the Rule's compliance date would "provide entities with sufficient time to assess the impact of such rules on their portfolios" after these swap-related rulemakings were concluded. 77 Fed. Reg. at 11,258. But post-hoc assessment by regulated entities cannot substitute for the requisite pre-enactment evaluation by the agency itself.

The district court offered a similarly unsatisfactory response. *See* A-80. The district court assessed rulemakings issued by the CFTC *after the rulemaking* at issue here, and determined—on the basis of its independent reading—that the regulatory definition of "swap" ultimately did little to change the statutory definition enacted in Dodd-Frank. *See* A-80. Even the Commission did not advance this rationale before the district court, and for good reason: The Commission could not *know* at the time of the rulemaking that it would adopt a definition of "swap" similar to the statutory definition. These post-rulemaking developments therefore cannot retroactively cure the defect. *See Chenery*, 318 U.S. at 87-88.

3. Finally, the Commission deprived itself of the ability to assess the Rule's costs by failing to obtain relevant market data. The Commission frankly acknowledged that "current data and information does not allow the Commission to evaluate the difference in market impact at various threshold levels." 77 Fed. Reg. at 11,278. Commenters urged the Commission to undertake the study necessary to obtain the missing data. *See* A-1024 (Vanguard Comment); A-1113 (Invesco Comment). And commenters identified ways that the Commission might go about obtaining the data that it needed. *See*, *e.g.*, A-846 (ICI Roundtable Comment). At a roundtable held in connection with the rulemaking, where the issue was discussed at length, the Assistant Director of the Commission's Division of Clearing and Intermediary Oversight responded as follows: "Even though my

training . . . would say you get the data first, I'm not seeing it in this current political and budgetary environment." A-1253 (statement of Mr. Walek). The current "political and budgetary environment," however, does not excuse the Commission from its obligation to "get the data first" and only then fashion a reasonable regulatory policy that takes the data into account.

* * *

The Commission failed to take readily available steps to determine the costs and benefits of its Rule. The Commission adopted the Rule in a manner that deprived it of the ability to meaningfully determine the Rule's costs—a fact the Commission implicitly acknowledged when it declined to assess the Rule's burdens under the PRA. At the same time, it failed to determine whether the Rule would provide any benefits in the context of existing SEC and FINRA regulations, and in fact relied on benefits that the SEC already provides—including the "two significant benefits" at the center of its rationale. It thus conducted a cost-benefit "analysis" that analyzed neither costs nor benefits. That is no analysis at all.

III. The Commission Failed To Provide A Reasoned Justification For Significant Aspects Of Its Rule.

The Commission also failed to provide a reasoned explanation to justify specific aspects of its rulemaking.

1. *Inclusion Of Swaps Within The Registration Thresholds*. The Commission gave an illogical and inadequate explanation for its decision to include swaps within the registration thresholds.

Commenters urged that—although Dodd-Frank expanded the statutory definition of a CPO to include entities that trade in swaps (*see* Pub. L. No. 111-203, § 721(a)(6), 124 Stat. 1659-60)—the Commission was not required to include swaps in the calculation of whether an investment company met the Rule's registration thresholds. Including swaps was unnecessary because Dodd-Frank and its implementing regulations already provided an "extensive reporting framework with respect to swaps." A-866 (SIFMA Comment). And it was premature because development of that regulatory regime was in flux. A-1115 (Invesco Comment).

The Commission's response was nonsensical. Observing that the statutory definition of a CPO includes trading in swaps, the Commission stated that, "if [it] were to adopt the trading threshold and only include futures and options as the basis for calculating compliance with the threshold, the swaps activities of the registered investment companies would still trigger the registration requirement notwithstanding the exclusion of swaps from the calculus." 77 Fed. Reg. at 11,258. Thus, "[i]f swaps were excluded, any swaps activities undertaken by a registered investment company would result in that entity being required to register." *Id.* This reasoning proceeds on the bizarre assumption that the Commission *could not*

fashion language that would exclude swaps from the determination of whether an investment company met the definition of a CPO. Of course the Commission's drafting skills are not so limited: It could simply have excluded swaps from the numerator as well as the denominator.

The Commission's reasoning was arbitrary and capricious, and amounted to a failure even to consider a narrower alternative proposed by commenters. It also undermines the post-enactment effort by the Commission—embraced by the district court—to somehow link the Rule to Dodd Frank's expansion of the Commission's jurisdiction to include swap transactions. *See*, *e.g.*, A-69. If the Rule were truly meant to address trading in swaps, *that* would be the logical response to the suggestion that the Commission exclude swaps from the registration threshold. But that is not at all what the Commission said in the rule release; instead, the Commission offered an irrational response that itself provides grounds for vacatur.

2. *Definition of Bona Fide Hedging*. The Rule defines *bona fide* hedging transactions—which are excluded from the calculation of whether an investment company's activities trigger the trading threshold—with reference to 17 C.F.R. §§ 1.3(z)(1) and 151.5. *See* 77 Fed. Reg. at 11,283. Those provisions, in turn, limit the definition of *bona fide* hedging to transactions designed to offset exposure in the physical marketing channel. The Commission failed to provide a reasoned justification for rejecting broader definitions proposed by commenters.

The Commission defended its approach on the ground that "*bona fide* hedging transactions are unlikely to present the same level of market risk as they are offset by exposure in the physical markets." 77 Fed. Reg. at 11,256. But the Commission did not explain why it was excluding *other* risk mitigation strategies also offset by exposure in other markets—a characteristic common to a wide range of risk mitigation transactions. As Commissioner Sommers stated in dissent, "[a] risk mitigation position is, by definition, a position that 'offsets' exposure in another market. Both are hedges and there is no explanation as to why the Commission believes that *bona fide* hedges are less risky." *Id.* at 11,344. Commenters pointed out that the Commission had adopted broader definitions of *bona fide* hedging in other contexts. *See* A-870 (SIFMA Comment); A-984-85 (ICI Comment). The Commission failed to explain why it believed a similar approach would be inappropriate here.

As the district court acknowledged, these concerns were "exacerbated" after the Rule's promulgation, A-88, when another district court judge vacated the Commission's regulation promulgating section 151.5 and amending section 1.3(z)(1)—the two provisions to which the Rule refers. *See ISDA*, 2012 WL 4466311, at *25. In response to this development, the Commission staff issued a letter stating that the vacatur of these cross-referenced provisions made no difference at all; it would continue to apply the now-vacated definition of *bona fide*

hedging. *See* A-270-80. For at least some entities, this letter functions as a threat to apply a more restrictive definition of *bona fide* hedging than the definition now on the books; it is thus a patent imposition of binding regulatory restrictions through "guidance" issued without notice and comment. *See Syncor Int'l Corp. v. Shalala*, 127 F.3d 90, 96 (D.C. Cir. 1997) (vacating attempt to promulgate substantive rule without notice and comment). The Commission cannot cure this post-enactment defect by its staff issuing a letter. To the contrary, because the agency "assumed the validity of" the amendments to the *bona fide* hedging definition, and because those amendments have been vacated, the Rule "must also now" be vacated. *Solite Corp. v. EPA*, 952 F.2d 473, 493 (D.C. Cir. 1991) (per curiam); *see also Mobile Oil Corp. v. EPA*, 35 F.3d 579, 584 (D.C. Cir. 1994).

3. *Adoption of a Specific Trading Threshold*. Finally, the Commission failed to offer a reasoned explanation for its decision to set the trading threshold at five percent.

There was abundant evidence in the record that five percent was too low. The Commission in 2003 explained that the five percent threshold had come to limit the activities of investment companies "to a much greater extent" than originally intended, due to changes to margin levels for stock index futures and security futures. *See* 68 Fed. Reg. 12,622, 12,625 (Mar. 17, 2003) ("2003 Proposing Release"). And, in the instant rulemaking, the Commission acknowledged that "mar-

gin levels for securities product futures are significantly higher" than five percent and that "levels for swaps margining may be as well." 77 Fed. Reg. at 11,256; *see also* A-900 (Institutional Investors Comment) ("The five percent limit does not reflect current market practices."). The Commission stated that its Rule was intended to target "de facto" commodity pools, 76 Fed. Reg. at 7,983, but commenters submitted data showing that the Rule as proposed would in fact sweep far more broadly, *see* A-982 (ICI Comment).

In response to this evidence, the Commission reasoned that it had "previously determined that five percent is an appropriate threshold." 77 Fed. Reg. at 11,256. As support, the Commission cited the same 2003 rulemaking in which it had *eliminated* the registration threshold for investment companies, in part because it had determined that the existing five percent threshold was too low; in the cited passage, the Commission imposed a five percent threshold on an entirely different set of entities. *Id.* (citing 2003 Adopting Release at 47,225). The Commission's reliance on the *less* relevant portion of that 2003 rulemaking, while entirely ignoring the *more* relevant portion, was irrational.

IV. The Commission Failed To Afford Adequate Opportunity For Notice And Comment.

The Commission also violated the command that an agency "give interested persons an opportunity to participate in the rule making," 5 U.S.C. § 553(c), as it

failed to provide adequate notice of its final regulation. The proposal published by the Commission fell short in at least two respects.

First, the proposal's discussion of costs and benefits did not adequately set out the basis for the final cost-benefit analysis. *See Chamber of Commerce v. SEC*, 443 F.3d 890, 901-05 (D.C. Cir. 2006). The proposal included less than a page of cost-benefit analysis, and of that less than one full sentence was addressed specifically to the costs and benefits of the trading and marketing thresholds. *See* 76 Fed. Reg. at 7,988 ("[F]ailing to adopt revisions to [Section] 4.5 . . . would result in disparate treatment of similarly situated collective investment schemes . . . .").

Second, the Commission did not give commenters adequate notice of the seven-factor test that—the Commission announced in the rule release—will guide application of the marketing threshold. *See* 77 Fed. Reg. at 11,259. These factors were set out nowhere in the proposal; they were proposed by a commenter, but an agency cannot "bootstrap notice from a comment." *AFL-CIO v. Donovan*, 757 F.2d 330, 340 (D.C. Cir. 1985) (internal quotation marks omitted).

V. The Rule's Deficiencies Require Vacatur.

In light of all the foregoing, the Rule's amendments to Sections 4.5 must be vacated. The APA is unambiguous: A rule "shall" be vacated if inconsistent with the requirements of that Act. 5 U.S.C. § 706(2)(A); *see also NRDC v. EPA*, 489 F.3d 1250, 1262 (D.C. Cir. 2007) (Randolph, J., concurring). Indeed, when an

agency has relied on alternative grounds to support a regulatory choice and *even one* of those grounds is deficient, the practice within this circuit is "ordinarily [to] vacate the [rule] unless [it is] certain that [the agency] would have adopted it even absent the flawed rationale." *Nat'l Fuel Gas Supply*, 468 F.3d at 839. And the need for vacatur is especially pronounced where, as here, the "seriousness of the . . . deficiencies" creates such a great "doubt whether the agency chose correctly." *Allied-Signal, Inc. v. Nuclear Regulatory Comm'n*, 988 F.2d 146, 150 (D.C. Cir. 1993).

The factors that have caused courts to remand without vacatur in certain cases are absent here. Public health and safety are not threatened. *NRDC*, 489 F.3d at 1265-67 (Rogers, J., concurring in part and dissenting in part). To the contrary, the Commission has never articulated *any* adequate explanation why its Rule is necessary in light of existing, comprehensive regulation of investment companies. And this is not a case where the regulatory "egg has been scrambled"; in fact, vacatur will help maintain "the status quo ante." *Milk Train, Inc. v. Veneman*, 310 F.3d 747, 756 (D.C. Cir. 2002) (internal quotation marks omitted); *see also Am. Equity*, 613 F.3d at 179. If the Rule's implementation is allowed to continue unabated, investment companies and their advisers will be subjected to duplicative and unnecessary regulation by two separate agencies, notwithstanding the Commission's

failure to adequately consider the costs of such a regime. The Rule must be vacated to avoid that unwarranted result.

CONCLUSION

For the foregoing reasons, the Rule should be vacated, and the district court's decision affirming the Rule should be reversed.

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Respectfully submitted,

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Dated: January 30, 2013

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CERTIFICATE OF SERVICE

Pursuant to Federal Rule of Appellate Procedure 25(d), I hereby certify that on this 30th day of January, 2013, the foregoing Brief for Appellants was electronically filed with the Clerk of Court for the United States Court of Appeals for the District of Columbia Circuit using the CM/ECF system. I also hereby certify that I caused 8 paper copies to be hand delivered to the Clerk's Office.

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