IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

INVESTMENT COMPANY INSTITUTE,
1401 H St., N.W.
Suite 1200
Washington, DC 20005

and

CHAMBER OF COMMERCE OF THE
UNITED STATES OF AMERICA,
1615 H St., N.W.
Washington, DC 20062

Plaintiffs,

v.

UNITED STATES COMMODITY FUTURES
TRADING COMMISSION,
3 Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Defendant.

Case: 1:12-cv-00612
Assigned To : Howell, Beryl A.
Assign. Date : 4/17/2012
Description: Admin. Agency Review

COMPLAINT

Plaintiffs INVESTMENT COMPANY INSTITUTE and CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA for their complaint against Defendant, UNITED STATES COMMODITY FUTURES TRADING COMMISSION, allege, by and through their attorneys, on knowledge as to Plaintiffs, and on information and belief as to all other matters, as follows:

I. INTRODUCTION

1. This is a lawsuit under the Administrative Procedure Act challenging a rule recently promulgated by the U.S. Commodity Futures Trading Commission ("CFTC" or "Commission"). The Commission amended 17 C.F.R. § 4.5 ("Section 4.5") to require advisers

to mutual funds and other registered investment companies to register with the CFTC as commodity pool operators if the investment company engages in non-hedging commodity trading exceeding certain thresholds, or if it makes statements that the CFTC regards as marketing a product as a vehicle for trading in the commodity markets. *See* Final Rule, Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11,252 (Feb. 24, 2012) ("the Rule"). Registration carries with it a host of attendant burdens, including reporting and recordkeeping requirements, qualification testing of associated persons, disclosure obligations, restrictions on content of promotional materials, and regulation and oversight by both the CFTC and a self-regulatory organization for the commodities industry. The Commission compounded those burdens in the same rulemaking by amending 17 C.F.R. § 4.27 to impose new quarterly reporting obligations on commodity pool operators. *See* 77 Fed. Reg. at 11,285.

2. Investment companies and their advisers already are among the most highly regulated entities in the financial industry. Partly for that reason, in 2003 the Commission excluded investment companies from CFTC regulation because those entities were "otherwise regulated" by the Securities and Exchange Commission ("SEC"). 68 Fed. Reg. 12,622, 12,625 (Mar. 17, 2003) ("2003 Proposing Release"). Prior to that time, investment companies generally had restricted their investment in commodity instruments due to the burdens associated with being subject to redundant and potentially conflicting regulation by multiple federal agencies. In excluding investment companies from CFTC registration and accompanying oversight by the agency and by a self-regulatory organization, the Commission explained that exclusion would "encourage and facilitate participation in the commodity interest markets" by investment

companies, and would therefore provide the "benefit to all market participants of increased liquidity." *Id.*

3. In adopting the rule in issue here the Commission effectively reversed those determinations, yet it nowhere explained or determined in any manner that SEC regulation was proving to be insufficient, or that the benefits of increased liquidity no longer justified exemption from registration. Indeed, in clear disregard for the most basic requirements of reasoned agency action, the Commission simply ignored and declined to mention key elements of the reasoning it had previously followed in lowering the barriers to participation in the commodities markets that it was now raising again. This new Rule is in fact significantly more restrictive than the regime the Commission rejected in 2003, as it requires, for the first time, registration of certain advisers to investment companies on the basis of their trading in swaps or marketing the investment company as a vehicle for trading in the swaps markets.

4. The Commission is under a special, heightened statutory duty to consider the costs and benefits of the regulations it adopts, including their effects on efficiency and competition. 7 U.S.C. § 19(a). Yet, at critical junctions in its decision-making leading to adoption of the Rule, the Commission failed to perform the most basic tasks of an appropriate cost-benefit analysis. As the U.S. Court of Appeals for the District of Columbia Circuit explained scarcely two years ago, the benefits of a new financial industry regulation cannot meaningfully be appraised without first examining the regulatory requirements that currently apply to the products in issue, comparing them to the requirements to be imposed, and then assessing what incremental value investors will receive from the added regulatory burdens and requirements. *See Am. Equity Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010). The Commission took none of those steps and failed as well in assessing the Rule's costs, even

admitting that it lacked the information necessary to perform the cost analysis required by the Paperwork Reduction Act. 77 Fed. Reg. at 11,272. The Commission therefore simply declined to perform this part of its statutorily-mandated cost-benefit analysis, while nonetheless proclaiming that the Rule's benefits justify its costs. In dissent, Commissioner Sommers warned: "It is unlikely, in my view, that the cost-benefit analysis supporting the rules will survive judicial scrutiny if challenged." *Id.* at 11,344.

5. For these reasons, and for the reasons set forth below, Plaintiffs respectfully request that this Court hold unlawful and set aside the amendments to Section 4.5, Section 4.27, and related provisions; enjoin the Commission from implementing or enforcing those amendments or giving them effect in any manner; and order such other relief as may be appropriate.

II. PARTIES

6. Plaintiff Investment Company Institute ("ICI") is an association that represents United States registered investment companies, including open-end investment companies (the most common kind of investment company, which includes mutual funds and most exchange-traded funds), closed-end investment companies, and unit investment trusts. ICI has three core missions: to encourage adherence to high ethical standards by all industry participants; to advance the interests of funds, their shareholders, directors, and investment advisers; and to promote public understanding of investment companies. As part of these missions, ICI pursues an extensive research program and is the primary source of aggregate industry data relied on by government regulators, industry participants, and independent observers. Members of ICI manage total assets of $13.3 trillion and serve more than 90 million shareholders.

7. Plaintiff Chamber of Commerce of the United States of America ("Chamber") is the world's largest business federation. It represents 300,000 direct members and indirectly

represents the interests of more than three million companies and professional organizations of every size, in every industry sector, and from every region of the country. Chamber members transact business throughout the United States and a large number of countries around the world. An important function of the Chamber is to represent the interests of its members in matters before Congress, the Executive Branch, and the courts. Chamber members and their subsidiaries include advisers to registered investment companies. The Chamber also is invested in investment companies that, as a consequence of the rule, will be compelled to comply with burdensome and redundant CFTC regulations.

8. Defendant CFTC is an agency of the United States government subject to the Administrative Procedure Act. *See* 5 U.S.C. § 551(1); 7 U.S.C. § 2(a)(2).

III. JURISDICTION AND VENUE

9. This action arises under the Administrative Procedure Act, 5 U.S.C. §§ 500 *et seq.*, and the Commodity Exchange Act, 7 U.S.C. §§ 1 *et seq.* ("CEA"). Jurisdiction therefore lies in this Court under 28 U.S.C. § 1331.

10. Plaintiffs have standing to bring this suit on behalf of their members because investment companies and their advisers that would be directly affected by the Rule would have standing to sue in their own right; because the interests they seek to protect are germane to their purpose; and because neither the claim asserted nor the relief requested requires an individual member to participate in this suit. *Theodore Roosevelt Conservation P'Ship v. Salazar*, 616 F.3d 497, 507 (D.C. Cir. 2010). The Chamber also has standing as an investor that wishes to be able to invest in investment companies offering exposure to the commodities markets that are not subject to burdensome, redundant regulation by multiple federal agencies.

11. Venue is proper in this Court under 28 U.S.C. § 1391(e) because this is an action against an agency of the United States that resides in this judicial district and a substantial part of the events or omissions giving rise to this action occurred in this judicial district.

IV. BACKGROUND

A. Regulation of Registered Investment Companies

12. Registered investment companies—including mutual funds, closed-end funds, exchange traded funds, and unit investment trusts—are some of the most highly regulated entities in the American financial system. *See* Clifford E. Kirsch and Bibb L. Stench, 1 *Mutual Funds and Exchange Traded Funds Regulation*, § 1:4.1 (3d ed. 2011) ("A mutual fund is one of the most regulated types of companies in the United States."). They are the only companies regulated by all four major federal securities laws: the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, and the Securities Exchange Act of 1934.

13. The Investment Company Act of 1940 ("ICA"), 15 U.S.C. §§ 80a-1 *et seq.*, "imposes an extensive federal regulatory structure on investment companies." Thomas P. Lemke, Gerald T. Lins, and A. Thomas Smith, 1 *Regulation of Investment Companies* § 1.01 at 1-2 (2011). The ICA defines an investment company, with certain caveats, as an issuer that "holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities" or that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets." 15 U.S.C. § 80a-3.

14. Under the ICA, investment companies are required to register with the SEC and are subject to extensive restrictions and obligations set by statute and SEC regulations. *See*

generally 15 U.S.C. §§ 80a-1 *et seq.*; 17 C.F.R. part 270; *see also* ICI, Comment (Apr. 12, 2011), at 7; Fidelity Investments, Comment (Apr. 12, 2011), at 4; Thomas P. Lemke, Gerald T. Lins, and A. Thomas Smith, 1 *Regulation of Investment Companies* § 1.01 at 1-2 (2011) ("Unlike other federal securities laws, which are designed to protect investors primarily through disclosure, the [ICA] imposes substantive requirements on the operations of investment companies in addition to disclosure requirements."); Louis Loss, Joel Seligman, and Troy Paredes, 1 *Securities Regulation* 379 (4th ed. 2006) ("[T]he Investment Company Act is the most complex of the entire SEC series."). For example:

a. Investment companies are required to file a registration statement with the SEC. *See* 15 U.S.C. § 80a-8(b). SEC Form N-1A implements this requirement for open-end investment companies, such as mutual funds and most exchange-traded funds, and directs investment companies to make extensive disclosures regarding the fundamental characteristics and investment risks of the fund, including its investments in derivatives and any particular risks raised by those investments. Investment companies must provide detailed information regarding fees and expenses, investment strategies, principal investing risks, legal proceedings, and financial highlights. Form N-1A also requires conflicts-related disclosure, including information regarding portfolio holdings, management of fund investments by portfolio managers, and payments to broker-dealers and other financial intermediaries. For closed-end investment companies, Form N-2 requires similar disclosures, including information regarding fees, expenses, investment objectives and policies, principal risks, legal proceedings, and management. The contents of both Form N-1A and N-2 are made available to the public.

b. Investment companies must provide to shareholders semi-annual and annual reports containing the investment company's financial statements, and must file these reports publicly with the SEC. *See* 15 U.S.C. § 80a-29; 17 C.F.R. § 270.30e-1. Investment companies also must file quarterly reports with the SEC that are publicly available to investors, and that contain a schedule of investments and other disclosures. *See* 15 U.S.C § 80a-29; 17 C.F.R. §§ 270.30b1-5, 30b2-1.

c. Investment companies are required to maintain books and records, generally for at least six years. *See, e.g.*, 15 U.S.C. § 80a-30; 17 C.F.R. § 270.31a-1 (directing investment companies to "maintain and keep current the accounts, books, and other documents . . . which constitute the record forming the basis for financial statements required to be filed," as well as, among other things, journals of purchases and sales and ledgers reflecting all asset, liability, reserve, capital, income, and expense accounts); *see also id.* §§ 31a-2, 31a-3. The SEC has authority to inspect these records "at any time," 15 U.S.C. § 80a-30(b), and does in fact conduct inspections of the books and operations of investment companies.

d. Investment companies are subject to significant conflict of interest provisions, including prohibitions on transactions between investment companies and their affiliates and a requirement of independent board oversight. *See* 15 U.S.C. §§ 80a-10, 80a-17.

e. Investment companies are subject to restrictions intended to limit risk associated with leverage, including strict capital and asset coverage requirements that limit the extent to which they may engage in derivative transactions. The law limits the ability of an investment company to issue a "senior security," which is defined in part as

an instrument evidencing indebtedness. 15 U.S.C. § 80a-18. The SEC has interpreted this term to include certain derivatives, among them swaps; it has stated that the prohibitions for senior securities will not be implicated if an investment company "covers" the derivatives transaction by setting aside assets "to meet the obligations arising from such activities." Securities Trading Practices of Registered Investment Companies, 44 Fed. Reg. 25,128, 25, 132 (Apr. 27, 1979); *see also* Use of Derivatives by Investment Companies Under the Investment Company Act of 1940, 76 Fed. Reg. 55,237, 55,239–41 (Sept. 7, 2011) ("SEC Concept Release"). The SEC staff periodically reviews its policies and guidance on investment companies' use of derivatives to ensure that they reflect recent developments. *See* SEC Staff Evaluating the Use of Derivatives by Funds, available at http://www.sec.gov/news/press/2010/2010-45.htm; SEC Concept Release at 55,237–38; *see also* Registered Investment Company Use of Senior Securities—Select Bibliography, available at http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm.

f. Investment companies are required to conform to regulations that restrict their advertising activities. *See* 17 C.F.R. § 230.482.

g. Each investment company must have its own chief compliance officer, hired by the fund's independent board of directors, and compliance policies and procedures that are reasonably designed to ensure compliance with the federal securities laws. *See* 17 C.F.R. § 270.38a-1.

h. Investment companies are subject to anti-fraud provisions, including Section 34(b) of the Investment Company Act of 1940, Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, and Section 17(a)(3) of the Securities Act of 1933.

15. Advisers to investment companies are subject to additional regulation under the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 *et seq.*, including registration and extensive public disclosure requirements, *id.* § 80b-1, reporting and recordkeeping requirements, *id.* § 80b-4, anti-fraud provisions, *id.* § 80b-6, restrictions on advertisements, 17 C.F.R. § 275.206(4)-1, and segregation of investor assets, *id.* § 275.206(4)-2. Investment advisers register with the SEC using Form ADV, which mandates public disclosure of assets under management, business practices, potential conflicts of interest, ownership, clients, employees, affiliations, and disciplinary proceedings involving the adviser or its employees. Registered investment advisers must have a chief compliance officer and must adopt and implement compliance policies and procedures tailored to the needs of the firm. *See id.* § 275.206(4)-7.

16. Investment companies' principal underwriters and distributing broker-dealers, in addition to being regulated by the SEC, are subject to extensive regulatory oversight by the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory organization with authority and responsibilities conferred by federal law. Requirements imposed by FINRA include qualifications testing of associated persons, restrictions on use of client information, restrictions on advertising, margin requirements, trading standards and practices, and disclosure, reporting, and recordkeeping obligations. *See* FINRA Rules, *available at* http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=607&record_id=609.

17. Finally, investment companies and their advisers are subject to CFTC regulations that apply broadly to market participants regardless of registration status. Thus, investment companies are subject to CFTC large-trader reporting requirements under 17 C.F.R. § 4.18, which require certain participants in the commodities markets to make extensive disclosures

regarding, among other things, the trader's registration status, affiliations, and accounts. Investment companies and their advisers are also subject to the CFTC's recently-adopted swap reporting and recordkeeping requirements. *See* 77 Fed. Reg. 2,136 (Jan. 13, 2012); 77 Fed. Reg. 1,182 (Jan. 9, 2012).

B. Regulation of Commodity Pool Operators

18. A commodity pool operator ("CPO") is, broadly defined, an entity that pools money from investors in order to purchase commodity interests. The Commodity Exchange Act ("CEA") currently defines a CPO as a person engaged in the business of operating an investment trust, syndicate, or similar enterprise that, "in connection therewith, solicits, accepts, or receives from others, funds, securities, or property . . . for the purpose of trading in commodity interests," including any "commodity for future delivery, security futures product, or swap." 7 U.S.C. § 1a(11). Entities meeting the definition of a CPO are required to register with the CFTC, *id.* § 6k, which carries with it a host of additional regulatory requirements. Absent the CEA, private commodity pools would not be subject to federal financial regulatory agency oversight and commodity pools that are offered publicly would be subject only to the Securities Act of 1933, and not the more demanding requirements of the Investment Company Act of 1940.

19. Under the CEA, the Commission has authority to exclude entities from the definition of a CPO, and hence from the registration requirement and its attendant regulatory burdens. *Id.* § 1a(11)(B) ("The Commission, by rule or regulation, may include within, or exclude from, the term 'commodity pool operator' any person . . . if the Commission determines that the rule or regulation will effectuate the purposes of this chapter."). The Commission has exercised this authority to exempt from the definition of a CPO a wide variety of entities that would otherwise be subject to overlapping regulatory oversight, including insurance companies, banks, and pension plans. *See* 17 C.F.R. § 4.5. Since 1984, the Commission has also exercised

this authority to exclude investment companies registered with the SEC. *See* 49 Fed. Reg. 4,778 (Feb. 8, 1984).

20. Prior to 2003, the Commission required persons claiming this exclusion with respect to an investment company to file a notice of eligibility representing that they met two threshold requirements. First, under the so-called "trading threshold," a person claiming exclusion was required to represent that the investment company used commodity futures or options contracts solely for bona fide hedging purposes or that the initial margin and premiums required to maintain non-bona fide hedging positions would not exceed five percent of the liquidation value of the investment company's portfolio. *See* 17 C.F.R. § 4.5(c)(2)(i) (2002). Second, under the so-called "marketing threshold," a person claiming exclusion was required to represent that the investment company would not market participation to the public "as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures or commodity options markets." *Id.* § 4.5(c)(2)(ii). Investment companies responded to these requirements by generally restricting their investment in commodity instruments to meet these conditions, so that they would not be subject to burdensome dual regulatory requirements by both the SEC and the CFTC.

21. In 2003, after public notice and opportunity for comment, the Commission amended Section 4.5 to effectively exclude all registered investment companies from the definition of a CPO, by eliminating the trading and marketing thresholds. *See* 68 Fed. Reg. 47,221, 47,231 (Aug. 8, 2003) ("2003 Adopting Release"). The Commission explained that this change was warranted because the trading threshold had come to limit the activities of investment companies "to a much greater extent" than intended, due to changes to margin levels for stock index futures and security futures. *See* 2003 Proposing Release at 12,625. Revision of

Section 4.5 was therefore necessary "to take into account market developments and the current investment environment." *Id.*

22. The Commission also explained that elimination of both the trading and marketing thresholds was appropriate because investment companies are "otherwise regulated" by the SEC. 2003 Proposing Release at 12,625; 2003 Adopting Release at 47,223. The Commission concluded that there "should be no decrease in the protection of market participants and the public" resulting from the change, because the amendments merely relaxed the Commission's regulatory requirements "in order to be consistent with existing requirements under the federal securities laws and the SEC's rules." *Id.* at 47,230. These amendments to Section 4.5 were "intended to allow greater flexibility and innovation," the Commission said, "by modernizing the requirements for determining who should be excluded from the CPO definition" and 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." 2003 Proposing Release at 12,625.

23. Today the most common investment strategies for investment companies continue to involve investments in stocks or bonds. But investment companies now also use commodity instruments to manage their investment portfolios in a variety of ways. Many of these investment strategies are unrelated to speculation. *See* ICI Comment, at 17. For instance, commodity instruments (including futures or swaps tied to a broad-based securities index such as the S&P 500) may be used to hedge positions, to equitize cash that cannot be immediately invested in direct equity holdings, to adjust portfolio duration, or to manage bond positions. *Id.* A smaller portion of investment companies use commodity instruments to provide investors with some exposure to the commodity markets. *Id.* Many financial advisers recommend that

investors seek some exposure to the commodity markets as part of an asset allocation strategy, and as a hedge against inflation and other risks associated with other types of investments.

C. The Proposed Rule

24. On February 11, 2011, the Commission issued a Notice of Proposed Rulemaking ("NPRM") to impose trading and marketing thresholds even stricter than those that it had eliminated just eight years before. *See* 76 Fed. Reg. 7,989 (Feb. 11, 2011).

a. The NPRM proposed to put in place trading and marketing thresholds that closely resembled those that were in force prior to 2003, but that would, in practice, be significantly more restrictive because the thresholds would include swaps for the first time.

b. To meet the trading threshold, a person claiming exemption with respect to an investment company would have to represent that the investment company would use all "commodity futures or commodity options contracts, or swaps solely for bona fide hedging purposes," except to the extent that the aggregate initial margin and premiums required to establish non-hedging positions in "commodity futures or commodity option contracts, or swaps" did not exceed five percent of the liquidation value of the investment company's portfolio. *Id.* The NPRM defined the term "bona fide hedging" by reference to 17 C.F.R. § 1.3(z)(1), which defined a bona fide hedging transaction as a transaction designed to offset exposure in the physical commodity markets. To meet the marketing threshold under the proposed rule, a person claiming exemption with respect to an investment company would have to represent that the investment company would not market participation "as or in a commodity pool or otherwise as or in a vehicle for trading in . . . the commodity futures, commodity options, or swaps markets." *Id.* at 7,979.

25. Requiring advisers to investment companies to register with the CFTC as CPOs would subject investment companies and their advisers to an additional, vast regulatory apparatus that significantly compounds the regulatory oversight already provided by the SEC under four separate federal securities laws, and by FINRA under regulations applicable to broker-dealers and underwriters and distributors of investment company securities. Registered CPOs are subject to numerous CFTC regulations, including provisions governing reporting and disclosure to investors, 17 C.F.R. §§ 4.21-22, 4.24-25, recordkeeping, *id.* § 4.23, and segregation of investor assets, *id.* § 4.20. They are also subject to significant statutory requirements, including registration and reporting obligations, 7 U.S.C. § 6k, 6m, 6n, and a statutory anti-fraud provision, *id.* § 6o. And, registered CPOs are required to become members of the self-regulatory organization for the commodities industry, the National Futures Association ("NFA"), and must adhere to NFA rules and by-laws. *See id.* § 21; NFA Bylaw 1101. These impose additional reporting and disclosure obligations, restrictions on the content of promotional materials, a requirement to maintain business continuity and disaster recovery plans, and qualification testing of associated persons. *See* NFA Rules, *available at* http://www.nfa.futures.org/nfamanual/NFAManualTOC.aspx?Section=4.

26. In proposing to apply these extensive regulatory burdens, the NPRM offered no explanation for the Commission's decision to reverse the course that it had charted in 2003. The NPRM did state that "[i]n 2010, the Commission became aware of certain registered investment companies that were offering series of de facto commodity pool interests." 76 Fed. Reg. at 7,983. But the NPRM did not explain how it defined "de facto commodity pool interests," and undertook no meaningful analysis to determine the extent to which investment companies were offering such interests, or whether doing so had resulted in any harm to fund shareholders or the

commodity markets. In support of its assertion, the Commission cited a petition for rulemaking that had been filed by the NFA, but that petition referred only to "three entities" that had launched investment companies marketed explicitly to investors "as commodity futures investments." *See* NFA Petition for Rulemaking, *available at* http://www.nfa.futures.org/news/newsPetition.asp?ArticleID=3630. The NPRM also did not explain why increased participation by investment companies in the commodity markets—which was an express goal of the 2003 rulemaking, in order to provide greater liquidity—rendered existing SEC regulation insufficient or justified onerous new regulatory burdens on investment companies. Similarly, in 2003 the Commission had criticized the five percent non-hedging trading threshold as unduly restrictive, but the NPRM offered no rationale for again setting the threshold at five percent.

27. The Commission claimed that its proposal was necessary to "ensure consistent treatment of operators of commodity pools regardless of registration status with other regulators." 76 Fed. Reg. at 7,984. The Commission, however, failed to acknowledge that requiring investment company advisers to register would *not* result in equal treatment of investment company advisers and other registered CPOs. To the contrary, only investment companies and their advisers would be singled out for burdensome and redundant regulation by the SEC under the four major federal securities laws, as well as by the CFTC. Many other "substantially regulated" entities, including insurance companies, banks, trust companies, and ERISA fiduciaries, would continue to enjoy exemption from the definition of a CPO under Section 4.5.

28. The NPRM also did not offer any cogent explanation for the Commission's decision to include swaps within the proposed trading and marketing thresholds. The CFTC is

currently engaged in a joint rulemaking with the SEC to define the term "swap." *See* 76 Fed. Reg. 29,818 (May 23, 2011). Under common understanding, a swap is a contract that typically involves an exchange of one or more payments based on the value of a notional quantity of one or more commodities or other financial or economic interests, and that transfers between the parties the risk of a future change in such value without also transferring an ownership interest in the underlying asset or liability. The payments on a swap can be based on commodity prices and can also be based on interest rates or other financial terms. Because the Commission has not yet adopted a final definition of the term swap or established margin requirements for uncleared swap transactions—and because the Department of Treasury has not issued a final determination on whether it will exempt foreign exchange swaps and forwards from the definition of "swap"—it is impossible to know precisely how many firms will be required to register as a result of the Commission's decision to include swaps within the registration thresholds. However, as a result of that decision, the registration requirement proposed in the NPRM is certain to be significantly broader and more burdensome than its 2003 predecessor, which less than ten years before the CFTC had found to be too restrictive.

29. The Commodity Exchange Act requires that, before a rule is promulgated, "[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). Applying a similar provision under the securities laws, the United States Court of Appeals for the District of Columbia Circuit has vacated new SEC rules where that agency "neglected its statutory obligation to assess the economic consequences of its

rule," *Business Roundtable v. SEC*, 647 F.3d 1144, 1150 (D.C. Cir. 2011), and failed to sufficiently account for the extent to which the purported benefits of a rule were already provided by existing regulations, *Am. Equity Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010). Recently, members of Congress and certain of the CFTC's own Commissioners have questioned the adequacy of the agency's cost-benefit analyses. *See, e.g.*, Commissioner Jill E. Sommers, Opening Statement, Meeting on the Twelfth Series of Proposed Rulemakings under the Dodd-Frank Act (Feb.24, 2011) (criticizing the Commission's habitual "failure to conduct a thorough and meaningful cost-benefit analysis when we issue a proposed rule"); Letter from Frank D. Lucas, Chairman, Committee on Agriculture, and K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk Management, to A. Roy Lavik, Inspector General, CFTC (March 11, 2011), at 2 ("[T]he CFTC has taken a vague and minimalist approach to cost-benefit analysis that . . . fails to achieve the objectives of Section 15(a) of the CEA.").

30. Despite this statutory obligation to consider the costs and benefits of its proposed rule, the Commission offered only a superficial and conclusory cost-benefit analysis. The NPRM's discussion of costs and benefits generally did not distinguish between the proposed Section 4.5 registration requirement, and myriad other rule changes being proposed in the NPRM. *See* 76 Fed. Reg. at 7,988. The discussion directly addressing Section 4.5 amounted to less than a single sentence: failure to adopt the proposed registration requirement would, the Commission said, "result in disparate treatment of similarly situated collective investment schemes." *Id.* Once again, the Commission failed to acknowledge that the proposed rule would create "disparate treatment" by subjecting investment companies and their advisers to additional regulatory burdens, while leaving insurance companies, banks, trust companies, and ERISA fiduciaries able to rely on the 4.5 exemption.

D. Public Comment on the Commission's Proposal

31. The Commission received numerous comments on its proposal to amend Section 4.5. *See* 76 Fed. Reg. at 7,976.

32. Commenters assailed the Commission's proposal to re-impose the trading and marketing thresholds.

a. Commenters pointed to the continued validity of the Commission's 2003 rationale, noting that investment companies and their advisers are already subject to extensive regulation by the SEC and FINRA. *See, e.g.*, Vanguard, Comment (Apr. 12, 2011), at 4-5; Morgan Lewis, Comment (Apr. 12, 2011), at 4; Fidelity Comment, at 7; SIFMA, Comment (Apr. 12, 2011), at 3. Vanguard stated that existing regulations "obviate the need" to subject investment companies and their advisers "to redundant or inconsistent regulation." Vanguard Comment, at 5. SIFMA agreed that "CPO registration would create needless, duplicative compliance obligations." SIFMA Comment, at 4; *see also* Janus Capital Management, Comment (Apr. 12, 2011), at 2 (dual registration would "result in duplicative and unnecessary oversight" and "may confuse investors").

b. Commenters explained that the CFTC's own regulations recognize that SEC and FINRA standards are sufficient to protect investors and meet other regulatory objectives of the CFTC. *See* Letter from Karrie McMillan, General Counsel, ICI, to David Stawick, Secretary, CFTC (July 28, 2011), at 9. In particular, commenters pointed to 17 C.F.R. § 3.12(h)(1)(ii), which exempts the great majority of registered representatives associated with registered broker-dealers from registration as an "associated person" of a CPO and, hence, from the NFA's Series 3 licensing requirement.

c. Commenters also objected that overlapping CFTC and SEC regulation would subject investment companies and their advisers to inconsistent obligations with respect to, among other things, disclosure, reporting, and recordkeeping. *See, e.g.*, Invesco, Comment (Apr. 12, 2011), at 5-7; ICI Comment, at 29-33; SIFMA Comment, at 13-16. "[S]ignificant portions of the mutual fund industry will be subject to inconsistent and often conflicting SEC and CFTC regulations with which they will not be able to comply." Dechert, Comment (Apr. 12, 2011), at 13. As a result, investment companies may cease to operate in the commodity markets, leading to "market disruption, less liquidity for remaining market participants and harm to mutual funds' shareholders." *Id.*

d. In response to the NPRM's observation that investment companies were increasingly active in the commodities markets, commenters pointed out that facilitating such activity was in fact a goal of the 2003 regulation. *See, e.g.*, Morgan Lewis Comment, at 5-6. "The fact that registered investment companies are providing retail investors greater access to the commodities market . . . through an investment vehicle they are familiar with, that is highly regulated, and that will limit an investor's losses to the amount such investor invested . . . should be encouraged and facilitated," one commenter stated. *Id.* at 6; *see also* Dechert Comment, at 6.

33. Commenters also called the Commission's attention to its statutory obligation to conduct a thorough cost-benefit analysis under 7 U.S.C. § 19(a), and cautioned that the cost-benefit discussion in the NPRM was facially inadequate, failed to address key issues, and relied on conclusory statements to reach an insupportable conclusion. *See, e.g.*, ICI Comment, at 12 (expressing "deep concerns as to whether the CFTC's analysis would satisfy the applicable requirements of" the CEA's cost-benefit provision).

a. Commenters noted that the Commission had failed to determine the extent to which the proposed rule would provide any genuine benefits. The Commission had not compared the purported benefits of the proposed rule to the benefits already provided by existing regulation of investment companies and their advisers, and, if the Commission had undertaken such an analysis, commenters said, it would have found the purported benefits to be illusory. *See* ICI Comment, at 12 (stating that the Commission's asserted benefits "do not make sense in the context of registered investment companies, which are already heavily regulated" and that "any benefits . . . would largely be duplicative").

b. Because the NPRM focused on the purported benefit of added disclosure, commenters explained that existing disclosure and reporting requirements provide ample information about the commodity markets. The CFTC may obtain much of the information that it seeks through publicly-available disclosures already made by investment companies to the SEC. *See, e.g.*, Invesco Comment, at 5. And, investment companies are subject to other CFTC disclosure requirements that apply generally to all market participants. *See, e.g.*, Dechert Comment, at 10; *see also* Fidelity Comment, at 2; Tr. of Roundtable to Discuss Proposed Changes to Registration and Compliance Regime for Commodity Pool Operators and Commodity Trading Advisors (Jul. 6, 2011) ("Roundtable Transcript"), at 18-19, 37-38. Commenters explained that additional disclosure would not aid investors because providing similar but non-identical information at different times, in different formats, and to different agencies would cause investor confusion. *See* Janus Comment, at 2. For example, the CFTC requires CPOs of pools with more than $500,000 in assets—which would cover most investment

companies—to deliver *on a monthly basis* an account statement that includes an unaudited statement of operations and net assets, together with an affirmation by a corporate officer that the information is accurate and complete. 17 C.F.R. § 4.22; ICI Comment, at 31. Commenters and participants in a CFTC "roundtable" on the proposal also questioned whether the agency had the resources to process the information it was seeking once collected. Roundtable Transcript at 86-87.

c. Commenters catalogued significant costs that would be imposed by the proposed rule. The costs for investment companies—and ultimately their shareholders—include retaining counsel to reconcile and satisfy disparate regulatory requirements, upgrading systems to produce additional reports, hiring additional compliance professionals, satisfying additional registration requirements, preparing and distributing required disclosure documents, and establishing controls necessary to monitor and assure compliance with trading restrictions. *See* SIFMA Comment, at 20; ICI Comment, at 12. Ultimately, the proposal's costs would also include the loss of the increased liquidity that the 2003 amendment had intended to achieve. *See* CCMC, Comment (Apr. 12, 2011), at 7 (criticizing the Commission for giving "no consideration . . . to the potentially adverse consequences that the amendments could have on market liquidity and, by extension, the broader economy").

d. Commenters also objected that conducting this rulemaking before concluding ongoing swap-related rulemakings, including rulemakings defining swaps and setting margin levels for swap transactions, made it impossible to assess the full extent of the proposal's burdensome costs. Institutional Investors, Comment (Apr. 12, 2011), at 5; *see also* SIFMA Comment, at 21; Dechert Comment, at 15.

34. Commenters protested that the Rule improperly singled out investment companies and their advisers for redundant and overlapping regulation. Although Section 4.5 exempts numerous other entities—including insurance companies, banks, and pension plans—from the definition of CPO, the Commission narrowed Section 4.5's exemption only for investment companies, already among the most highly regulated financial market participants. Yet, commenters explained, those other exempted entities are subject to regulation that is far *less* comprehensive than the SEC's regulation of investment companies. *See* ICI Comment, at 8.

35. Commenters also criticized the serious gaps and flaws in the Commission's rationale for specific elements of its proposed trading and marketing thresholds.

a. ICI provided data illustrating the extraordinary overbreadth of the proposed registration thresholds. Although the Commission claimed that the rule targeted "de facto" commodity pools, ICI demonstrated that the proposal was not even minimally tailored to that objective. Based on information provided by ICI member firms that in total advise 2,111 registered investment companies, ICI found that as many as 485 investment companies would be unable to meet the criteria for exclusion under the proposed rule. ICI Comment, at 18. Of those, however, "only 29 . . . seek returns primarily based on a managed futures strategy or by providing exposure to physical commodities or other commodity-related strategies." *Id.* at 19. Thus, the "vast majority" of the investment companies that would be unable to meet the criteria for exclusion "pursue strategies outside the CFTC's intended reach." *Id.* at 20; *see also* Morgan Lewis Comment, at 7. ICI proposed ways to narrow the proposal, including excluding trading in swaps, expanding the definition of bona fide hedging, and raising the threshold for non-hedging transactions. ICI Comment, at 20-23.

b. Commenters pointed out that the Commission had not justified its decision to include swaps within the proposed registration thresholds, and that inclusion of swaps was premature. ICI stated, "[w]hile we understand that the CFTC obtained jurisdiction over swaps as a result of the Dodd-Frank Act"—the overhaul of the U.S. financial system enacted in response to the financial crisis of 2008—the Commission's "expanded jurisdiction does not relieve the agency of its obligation under the APA to explain the reasoning behind its proposal, including a clear rationale as to why *users* of swaps need to be registered." ICI Comment, at 9. SIFMA stated that inclusion of swaps was unnecessary because the "Commission is currently engaged in swap-related rulemaking pursuant to the Dodd-Frank Act" which will "establish an extensive reporting framework with respect to swaps trading by market participants" and "adequately address[ ] the CFTC's concerns with respect to increased transparency and accountability of swaps participants." SIFMA Comment, at 6; *see also* Fidelity Comment, at 4. Further, because development of that regulatory regime was still in flux—indeed, the term "swap" has not been defined—the effect of the five percent limitation could vary greatly depending on the final content of those regulations. *See* Invesco Comment, at 5; *see also* Janus Comment, at 2 ("Without a clear definition of 'swap' and certainty regarding which swaps will be subject to central clearing and what margin requirements will be, it is not possible to determine the implications of, or properly provide thoughtful comment to, the proposals relating to Rule 4.5."). Given this level of uncertainty, including swaps within the proposed threshold "would not provide the public with adequate notice of the substance of the rule the Commission intends to adopt." ICI Comment, at 10.

c. Commenters protested the Commission's unexplained decision to re-adopt a five percent non-hedging trading threshold, citing the Commission's own 2003 rulemaking that had criticized the five percent threshold as unduly restrictive. *See, e.g.*, Morgan Lewis Comment, at 7. Institutional Investors stated that "[t]he five percent limit does not reflect current market practices" and that it "does not appear . . . that there is any specific compelling justification for reinstating the limit at this level." Institutional Investors Comment, at 6-7; *see also* Fidelity Comment, at 11; SIFMA Comment, at 8. Commenters also recommended that the Commission engage in further study regarding the appropriate level at which to set any trading threshold. *See* Vanguard Comment, at 8; Institutional Investors Comment, at 7; Invesco Comment, at 3.

d. Commenters suggested expanding the definition of bona fide hedging—currently limited to transactions designed to offset exposure in the physical commodity markets—to make it less restrictive. In other contexts, including large-trader disclosure regulations and mandatory clearing requirements for swaps, the Commission had defined hedging to include broader categories of risk-management transactions, and commenters proposed that the Commission adopt a similarly broad definition here. *See* SIFMA Comment, at 10; ICI Comment, at 21-22; Fidelity Comment, at 10; Federated Investors, Comment (Apr. 12, 2011), at 2, 8-9. Federated Investors explained that "Congress, the CFTC, and the CFTC's staff advisory committees" had all "raised similar concerns with respect to application of [the bona fide hedging] definition to the use of financial futures by institutional investors." *Id.* at 5.

e. Finally, commenters criticized the proposed marketing threshold as vague and potentially overbroad. *See, e.g.*, SIFMA Comment, at 9; Invesco Comment, at 4. ICI

stated that "it is absolutely critical that the agency provide clear guidance articulating what the relevant factors are, how they will be weighted, and how the agency expects industry participants to apply them." ICI Comment, at 26. Further, ICI stated, "It is also critical that the public has an opportunity to comment on any test that the CFTC determines to propose." *Id.* at 27; *see also* Janus Comment, at 3.

E. The Final Rule

36. The Commission adopted the Rule by a vote of 4 to 1, and the final Rule was published in the Federal Register on February 24, 2012. 77 Fed. Reg. at 11,252. Numerous other regulatory changes were made in the same rule release, including amendments to the disclosure and reporting obligations of CPOs, and a new quarterly reporting requirement in Section 4.27. The Commission published corrections to the summary and the text of the Rule on March 26, 2012. 77 Fed. Reg. 17,328 (Mar. 26, 2012).

37. The final Rule adopted the trading threshold largely as proposed in the NPRM. *See id.* at 11,283. Thus, the Rule requires a person claiming exclusion with respect to an investment company to represent either that the company uses futures, options, and swaps solely for certain narrowly-defined bona fide hedging purposes, or that the initial margins and premium for non-hedging use of futures, options, and swaps will not exceed five percent of the liquidation value of the investment company's portfolio. The final Rule also added an "alternative net notional test," *id.* at 11,257, under which a person claiming exclusion with respect to investment companies may represent that "[t]he aggregate net notional value of commodity futures, commodity options contracts, or swaps positions not used solely for bona fide hedging purposes . . . does not exceed 100 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions." *Id.* at 11,283.

38. The final Rule also adopted the marketing threshold largely as proposed; thus, a person claiming exclusion with respect to an investment company must represent that the company will not market its fund as a commodity pool or as a means to trade in commodity futures, options, or swaps. *See id.* at 11,283. However, the rule release also listed seven factors that would be used to guide the marketing threshold's application. *See id.* at 11,259. Those factors were not set out in the NPRM and were not otherwise subject to public comment.

39. In its rule release, the Commission did not even mention—much less provide a reasoned explanation for abandoning—the rationale behind its 2003 amendment eliminating the trading and marketing thresholds. The Commission thus did not acknowledge, quote, or cite its prior conclusion that eliminating the registration threshold would increase liquidity without lessening protection for investors. *See* 2003 Proposing Release at 12,625; 2003 Adopting Release at 47,320. It nowhere concluded that the expected benefit in 2003 of increased liquidity had not materialized or that SEC regulation had proved inadequate to protect investors. The Commission did state that it was "aware . . . of increased derivatives trading activities by entities that have previously been exempted from registration with the Commission." 77 Fed. Reg. at 11,275. But the Commission did not provide any estimate of the extent that participation in the commodity markets by investment companies had increased; did not assess the degree to which such participation served incidental, risk-mitigation functions; and did not provide any explanation for why such participation—which had been a principal purpose of the 2003 change, and was regarded as a benefit—now justified subjecting those entities to overlapping and conflicting regulation. The Commission also claimed that "Dodd-Frank has given the Commission a more robust mandate to manage systemic risk" and that registration would provide "reliable information" to "execute this mandate." *Id.* But the Commission neither

explained why investment company exposure to commodities increased "systemic risk," nor addressed why "reliable information" could not be obtained by other means—such as information-sharing with the SEC—rather than subjecting investment companies to the full panoply of CFTC regulation of CPOs. Indeed, the Chairman of the CFTC himself recently stated that forms filed with the SEC would be more than sufficient to provide the CFTC the information it needs to discharge its responsibilities. *See* http://www.uschamber.com/webcasts/6th-annual-capital-markets-summit. The Commission also did not explain why similar disclosures were not needed from entities that remained exempt under Section 4.5, or why the activities of those entities would not increase systemic risk.

40. The closest the Commission came to acknowledging the rationale behind its 2003 regulation was a brief discussion of the addition of the net notional test to the trading threshold. *See id.* at 11,257. In 2003, the Commission considered a net notional test as an alternative to the elimination of the trading threshold, but concluded that the "otherwise regulated" nature of investment companies made it appropriate to eliminate the trading threshold altogether. 2003 Proposing Release at 12,625-26. In the instant rule release, the Commission stated that it "no longer believes that its prior justification for abandoning the alternative net notional test is persuasive." 77 Fed. Reg. at 11,257. In support of this assertion, the Commission stated only that it had "reinstate[d] the five percent trading threshold" and had generally "reverse[d]" the regulatory changes made in the 2003 rulemaking. *Id.* In other words, because the Commission had determined to re-impose the trading threshold, it no longer "found persuasive" its rationale for electing to eliminate the trading threshold. Yet, apart from asserting its new unelaborated "belief," the Commission nowhere explained its reasoned basis for concluding that the rationale put forward in 2003 was flawed.

41. The Commission undertook no analysis to establish that re-imposition of the trading and marketing thresholds was necessary in light of existing regulation. Although numerous commenters directed the Commission's attention to the SEC's extensive regulation of investment companies and their advisers, the Commission did not identify, analyze, or assess the protections already afforded to investors by those regulations, nor attempt to identify additional, necessary protection that would be provided by its Rule. The Commission did state that registration of investment company advisers with the Commission was appropriate "because Congress empowered the Commission to oversee the derivatives market." *Id.* at 11,255. That response, however, begs the question why the Commission should choose to exercise that power in this manner in this instance. And, it does nothing to explain why the Commission has chosen to continue to exempt numerous *other* "otherwise regulated" entities under Section 4.5, while burdening investment companies and their advisers with dual regulatory regimes.

42. To justify its Rule, the Commission cited two purported benefits of registration. First, the Commission stated—without elaboration—that registration would allow the Commission to ensure that registrants meet "minimum standards of fitness and competency." *Id.* at 11,254. Yet the CFTC's own regulations already recognize that, for the great majority of registered representatives associated with broker-dealers that distribute investment company shares, existing securities-industry licensing requirements are sufficient to satisfy the CFTC's standards for "fitness and competency." For example, a regulation at 17 C.F.R. § 3.12(h)(1)(ii) exempts registered representatives associated with broker-dealers from registering as an "associated person" of a CPO, effectively exempting them from the NFA's Series 3 licensing test. The Commission therefore provided no basis for its assertion that CFTC regulation would materially alter the "fitness" or "competency" of persons associated with investment companies.

43. Second, the Commission stated that registration would provide "a clear means of addressing wrongful conduct," as the Commission "has clear authority to take punitive and/or remedial action against registered entities." *Id.* The Commission, however, did not attempt to determine whether those benefits are provided by existing SEC regulation or whether additional CFTC oversight is necessary to afford those benefits to investors. In fact, the SEC has ample authority to bring enforcement actions against investment companies and their advisers to address wrongful conduct. Nor did the Commission identify any wrongful conduct by investment companies or their advisers, or give any reason to believe that wrongful conduct was occurring. Once again, the Commission also did not explain why these purported benefits were compelling only with respect to investment companies and not with respect to the other entities that remain exempt under Section 4.5.

44. The Commission also 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." *Id.* at 11,255. Yet the Commission did not acknowledge that advisers to investment companies and other registered CPOs would *not* be subject to "substantially identical regulatory obligations" under the Rule; rather, only investment companies and their advisers would be singled out by the CFTC for burdensome and overlapping regulation. Nor did the Commission identify what it meant by "substantially identical" services or undertake any analysis of the extent to which investment company advisers ensnared by its registration requirement were in fact providing services "substantially identical" to those offered by CPOs.

45. The Commission did forthrightly acknowledge that dual registration would subject investment companies and their advisers to conflicting SEC and CFTC regulations. *See*

id. at 11,272 ("The Commission acknowledges 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."). The Commission therefore announced in its rule release 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 thus adopted the Rule knowing that it would subject investment companies and their advisers to inconsistent obligations and that those obligations would have to be amended, but without having determined the final form of those amendments or the extent to which they would succeed in eliminating regulatory conflicts. Indeed, in the "harmonization" NPRM issued concurrently with the rule release, Commissioner Sommers stated that "[t]he proposed rules, if finalized in their current form, would not achieve true harmonization." 77 Fed. Reg. 11,345, 11,352 (Feb. 24, 2012). The Commission thus adopted the Rule despite the very real possibility that genuine harmonization of SEC and CFTC regulations will not be achieved.

46. In response to the charge that it had unreasonably singled out investment companies from among the entities exempted by Section 4.5, the Commission stated only that it "focused on registered investment companies because it is aware of increased trading activity in the derivatives area by such entities that *may not* be appropriately addressed in the existing regulatory protections." 77 Fed. Reg. at 11,255 (emphasis added). The Commission did not conclude that such trading "*is not*" appropriately addressed, and it offered no analysis in support of its conclusion that such trading "may not" be appropriately addressed.

47. The Commission also offered circular and non-responsive justifications in reply to commenters' concerns regarding specific aspects of the proposed trading threshold.

a. With respect to including swaps, the Commission noted that the Dodd-Frank Act amended the statutory definition of a CPO to include entities that engage in transactions involving swaps. *Id.* at 11,258. The Commission therefore reasoned 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." *Id.* 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 misreads Section 4.5, which excludes operators of *all* investment companies unless they trigger the trading or marketing thresholds, so that excluding swaps from the thresholds would result in the exclusion of more entities, not fewer. The Commission's reasoning also failed to address the obvious alternative of excluding swaps from the determination of whether an investment company should be included within the definition of a CPO.

b. With respect to the adoption of a five percent non-bona fide hedging threshold, the Commission acknowledged that "margin levels for securities product futures are significantly higher" than five percent and that "levels for swaps margining may be as well." *Id.* at 11,256. Despite this, the Commission stated, without explanation, that it "believes . . . that trading exceeding five percent of the liquidation value of a portfolio evidences a significant exposure to the derivatives markets" and "should subject an entity to the Commission's oversight." *Id.* At the same time, the Commission acknowledged that "current data and information does not allow the Commission to evaluate the difference in market impact at various threshold levels." *Id.*

at 11,278. The Commission made no attempt to obtain that information, or to undertake the further study urged in the comments. Instead, at a "roundtable" in connection with the rulemaking, the Assistant Director of the Commission's Division of Clearing and Intermediary Oversight admitted that, "[e]ven though my training . . . would say you get the data first, I'm not seeing it in this current political and budgetary environment." Roundtable Transcript at 84 (statement of Mr. Walek).

c. With respect to its restrictive definition of bona fide hedging, the Commission stated that "an important distinction between bona fide hedging transactions and those undertaken for risk management purposes is 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. The Commission did not address the fact that many risk management transactions not encompassed within its definition are likewise offset by exposure in other markets.

48. Finally, the Commission provided a fleeting cost-benefit analysis that failed to reasonably assess either the true benefits or the true costs of its Rule.

a. The Commission "recognize[d] that significant burdens may arise from the modifications to § 4.5." *Id.* at 11,278; *see also id.* at 11,276 ("The Commission has determined that these amendments will create additional compliance costs . . . ."). Yet, the Commission frankly acknowledged that it had not determined the full extent of the costs faced by investment companies and their shareholders. Those costs would necessarily turn on the degree to which the Commission succeeded in its proposal to harmonize conflicting SEC and CFTC regulations; given this uncertainty, the

Commission declined in the rule release to even attempt to calculate the added burden from the Rule as required by the Paperwork Reduction Act. *See id.* at 11,272.

b. Nor did the Commission make any attempt to determine the approximate number of firms that would be required to register or the aggregate cost of compliance across the investment company industry. In response to commenters' concern that the full impact of the Rule could not be meaningfully assessed without knowing the definition of swap and margin requirements for swap transactions, the Commission stated only that the compliance date for the regulation would "provide entities with sufficient time to assess the impact of such rules on their portfolios" after those matters were clarified by subsequent Commission rulemakings. *Id.* at 11,258. The Commission did not explain how such a post-rulemaking assessment could provide the public a meaningful opportunity to comment. Nor did the Commission explain how it could meaningfully assess the costs of the Rule without knowing how the Rule would operate or approximately how many firms would have to register.

c. The Commission frankly acknowledged that it could not determine the cost of setting the non-bona fide hedging threshold at five percent, as opposed to some other number. The Commission admitted that it lacked the data necessary to "evaluate the difference in market impact at various threshold levels." *Id.* Yet the Commission did not undertake the further study necessary to obtain that data.

d. The Commission likewise did not undertake to meaningfully assess the purported benefits that would result from its regulation. The Commission acknowledged that "the Commission and the SEC share many of the same regulatory objectives," *id.* at 11,278, but made no attempt to assess the extent to which the objectives of the Rule are

already met by existing SEC regulation. The Commission therefore failed to establish a proper baseline against which to measure the purported benefits of its Rule: When the Commission concluded that the Rule's registration requirement would "upgrade the overall quality of market participants" because it would allow the Commission to impose minimum standards of fitness and competency on persons associated with advisers to investment companies and to address wrongful conduct by investment companies and their advisers, *id.* at 11,277, it utterly failed to quantify or assess the extent to which these benefits were already provided by existing regulation or would be enhanced by the Rule.

e. Rather than assess the sufficiency of the SEC's regulation, the Commission asserted that the Rule was appropriate because "[t]he Commission's programs are structured and its resources deployed to meet the needs of the markets it regulates." *Id.* at 11,278. The Commission nowhere concluded that the programs and resources of the SEC are *not* adequately structured and deployed to protect investors in investment companies. Nor did the Commission undertake the comparative analysis necessary to reach such a conclusion or present any facts from which it would be possible to draw such an inference.

49. The Commission likewise offered only a cursory discussion of the factors listed in the cost-benefit provision of the CEA. *See* 7 U.S.C. § 19(a).

a. With respect to the protection of market participants and the public, the Commission stated that it "believes" its Rule will advance this interest "by requiring certain parties previously excluded or exempt from registration to be held to the same standards as registered operators and advisors" and that increased compliance costs would be "outweigh[ed]" by "the benefits of transparency." 77 Fed. Reg. at 11,280. Yet

the Commission nowhere assessed the extent to which these benefits are provided by existing regulation or may be provided by means that do not require subjecting investment companies and their advisers to the full range of CPO regulations.

b. With respect to the efficiency, competitiveness, and financial integrity of the futures markets, the Commission stated that the Rule would "enable the Commission to better oversee" the activities of investment companies and thus would "protect[ ] the integrity of the markets." *Id.* Again, the Commission nowhere concluded that such protection was lacking under the current regime. The Commission also stated that "the competitiveness of market participants will be enhanced" by the Rule because "similarly situated entities in the derivatives market will be subject to the same regulatory regime," *id.*, although the Rule will in fact subject investment companies and their advisers to obligations over and above those applicable to other CPOs and the commodity pools they sponsor. Nowhere did the Commission address its 2003 determination that increasing liquidity in the commodities markets was desirable. Nor did it address commenters' explanation that the rule would lead to less liquidity—and thus would impair the efficiency, competitiveness, and financial integrity of the futures markets—because investment companies would be less willing to engage in derivatives transactions that brought them close to the five percent threshold.

c. Finally, with respect to sound risk management, the Commission stated that registration would provide additional information that would allow the Commission "to better assess potential threats to the soundness of derivatives markets." *Id.* The Commission provided no basis for concluding that investment companies pose any threat or that any such "potential" threat is not already addressed by the SEC, and the

Commission did not acknowledge the possibility that it could acquire such information by means that would not impose substantial additional regulatory burdens.

50. In the same rulemaking that it amended Section 4.5, the Commission multiplied the regulatory burden being imposed on investment companies (and others) by adopting a new Section 4.27, which will require CPOs to file a report called Form CPO-PQR. Some entities will have to file the report with the Commission quarterly. 77 Fed. Reg. at 11,285-86, 11,295-96.

51. Commenters had criticized the Form CPO-PQR as unnecessary and burdensome, and the quarterly filing requirement as too frequent. *See* Seward & Kissel, Comment (April 12, 2011), at 7; Managed Funds Association, Comment (Apr. 12, 2011), at 14; ICI Comment, at 33. Commenters questioned whether the Commission had the resources necessary to meaningfully use the information that was to be reported. Dechert Comment, at 10. And, commenters noted that investment companies already file quarterly, semi-annual and annual regulatory reports with the SEC that provide detailed information generally comparable to that requested by Form CPO-PQR. ICI Comment, at 33 and App. A. At least with respect to investment companies, therefore, the Commission could obtain this data from the SEC, without imposing additional, burdensome reporting obligations.

52. The Commission nonetheless retained the reporting requirement in the final Rule, and provided that advisers to investment companies with $1.5 billion or more in aggregated pool assets under management will have to file the form quarterly. 77 Fed. Reg. at 11,269, 11,285-86, 11,294-95. In imposing this additional reporting requirement, the Commission stated that "[t]he sources of risk delineated in the Dodd-Frank Act with respect to private funds are also presented by commodity pools," and that this reporting would "provide the Commission with similar information to address these risks." *Id.* at 11,253. Yet the Commission nowhere explained how

investment companies presented the same types of risks—it merely asserted this to be so. Nor did the Commission explain why those purported risks justified imposing burdensome paperwork obligations that would substantially overlap with obligations already imposed by the SEC. The Commission nowhere determined what information already was disclosed to the SEC and shareholders and nowhere compared the content of those disclosures to Form CPO-PQR. And, to the extent that any information was *not* already disclosed to the SEC, the Commission nowhere explained why it could not limit the reporting requirement to that information. Finally, in response to commenters who pointed out that the Commission lacked the resources to sift through the requested data, the Commission stated that it planned to "leverage any limits on its resources through its coordination with NFA to accomplish the analysis necessary to make full use of the data." *Id.* at 11,274. The Commission, however, did not actually determine that either it or the NFA had the resources to make meaningful use of the data.

53. Commissioner Sommers dissented from the amendments to Section 4.5 and the adoption of Section 4.27. *See id.* at 11,343-44. Congress was "aware of the existing exclusions and exemptions for CPOs when it passed Dodd-Frank," she observed, yet it "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.* Commissioner Sommers stated that the rule release "gives a false impression that the data we gather will enable us to actively monitor pools for systemic risk, that we have the resources to do so, and that we will do so." *Id.* Her dissent also criticized specific aspects of the Commission's rationale, including the restrictive definition of bona fide hedging: The Commission offered "no explanation" for the differing treatment of bona fide hedges of

commodities versus other risk mitigation strategies. *Id.* And, Commissioner Sommers criticized the Commission's cost-benefit analysis, stating: "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.*

COUNT ONE:

**VIOLATION OF THE COMMODITY EXCHANGE ACT AND ADMINISTRATIVE PROCEDURE ACT—
INSUFFICIENT EVALUATION OF COSTS AND BENEFITS**

54. Plaintiffs incorporate by reference the allegations of the preceding paragraphs.

55. The Commodity Exchange Act requires that before a rule is promulgated, "[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).

56. The Commission entirely failed to discharge these statutory directives. With regard to benefits, the Commission could not determine whether the Rule meaningfully enhanced the information and protections available to investors unless it first examined the disclosure and protections already provided through regulation of investment companies and their advisers by the SEC. The Commission made no such appraisal, and therefore had no basis to conclude that its additional, burdensome regulatory requirements offered any discernable benefits above and beyond those already provided to investors.

57. The Commission's assessment of the costs imposed by the Rule on investment companies, their shareholders, and the public was also patently flawed. The Commission wholly

failed to consider or account for the costs the Rule would impose by decreasing liquidity in the commodities markets, even though—just nine years earlier—the Commission expressly had identified liquidity from investment companies as a principal benefit to be attained by exempting investment companies and their advisers from CFTC registration and regulation. The Commission openly admitted that it could not conduct a proper analysis of the Rule's costs under the Paperwork Reduction Act until the conclusion of its proposed harmonization rulemaking, which was only begun on the day the Commission adopted its amendments to Section 4.5. Similarly, without knowing the outcome of the ongoing rulemaking regarding swaps, the Commission could not even estimate the number of firms that would be required to register—an obvious determinant of the costs of the Rule. The Commission also failed to consider or collect other information crucial to its analysis, including information on the impact of various potential trading threshold levels to the liquidity in the financial markets.

58. Without determining the Rule's costs and benefits, the Commission could not reasonably conclude that the Rule would further the interests identified in Section 19(a). In nonetheless adopting the Rule on the basis of such a conclusion, the Commission violated Section 19(a) and violated the Administrative Procedure Act by proceeding in a manner that was arbitrary, capricious, and otherwise not in accordance with law.

59. Plaintiffs are therefore entitled to relief pursuant to 5 U.S.C. §§ 702, 706(2)(A), (C).

COUNT TWO:

VIOLATION OF THE ADMINISTRATIVE PROCEDURE ACT— ARBITRARY AND CAPRICIOUS AGENCY ACTION IN REQUIRING REGISTRATION AND REGULATION OF INVESTMENT COMPANIES AND THEIR ADVISERS

60. Plaintiffs incorporate by reference the allegations of the preceding paragraphs.

61. The Administrative Procedure Act requires an agency to examine the data that is relevant to its proposed action and to articulate a satisfactory explanation for its decision, including a rational connection between the facts found and the choices made. Further, when an agency abandons a position that it recently had adopted—and in favor of a position that it recently had rejected—the agency must provide a reasoned explanation for disregarding facts and circumstances that underlay the prior policy. *See FCC v. Fox Television Stations, Inc.*, 129 S. Ct. 1800, 1811 (2009).

62. In adopting the Rule in issue here, the Commission cited no credible evidence or sound reasons for CFTC registration and regulation of investment companies and their advisers. Further, the Commission failed to address or even acknowledge the reasons it gave in 2003 for lifting the requirements that, less than ten years later, it has decided to re-adopt and bolster. The Commission did not address—much less provide a reasoned explanation for disregarding—its prior conclusion that eliminating the registration thresholds would promote liquidity by increasing participation in the commodity markets. Nor did the Commission provide a reasoned explanation for disregarding its prior conclusion that the five percent threshold had become unduly restrictive over time; to the contrary, the Commission acknowledged that it lacked the information required to assess the merits of possible alternate trading thresholds. And, the Commission offered only conclusory statements to rebut its prior conclusion that registration of investment companies is unnecessary due to existing SEC regulation.

63. By requiring registration and regulation of investment companies and their advisers, and by re-imposing those requirements without acknowledging its reasons for rejecting them and explaining why those reasons no longer held, the Commission acted in a manner that was arbitrary, capricious, and otherwise not in accordance with the law.

64. Plaintiffs are therefore entitled to relief pursuant to 5 U.S.C. §§ 702, 706(2)(A), (C).

COUNT THREE:

VIOLATION OF THE ADMINISTRATIVE PROCEDURE ACT— ARBITRARY AND CAPRICIOUS AGENCY ACTION IN ESTABLISHING REGISTRATION THRESHOLD AND ADOPTING RELATED REQUIREMENTS AND RESTRICTIONS

65. Plaintiffs incorporate by reference the allegations of the preceding paragraphs.

66. In adopting the specific registration requirements set forth in the Rule, the Commission failed to satisfy its responsibilities under the Administrative Procedure Act to articulate a rational connection between the facts it found and the decisions it made, and to consider and respond to significant comments in the record.

67. For example, in explaining its decision to include swaps within the threshold, the Commission stated only that the Dodd-Frank Act had amended the statutory definition of CPO to include entities that traded in swaps. The Commission did not address the possibility of adopting a trading threshold that simply excluded trading in swaps from the determination of whether an investment company should be required to register as a CPO. It provided no cogent explanation for failing to adopt that approach.

68. The Commission also failed to provide an adequate explanation for its reliance on a restrictive definition of bona fide hedging. The Commission stated that the type of hedging transactions included within the definition pose less risk because they offset exposure in the physical commodity markets, but it did not explain its decision to exclude other risk mitigation strategies that offset exposure in other types of markets.

69. Nor did the Commission provide an adequate explanation for its decision to set the non-bona fide hedging threshold at five percent. To the contrary, the Commission

acknowledged that margin levels for several relevant types of transactions are or may be higher than five percent, and acknowledged that it lacked the market data needed to adequately assess the impact of a five-percent threshold.

70. Adoption of these requirements of the Rule was arbitrary, capricious, and otherwise not in accordance with law, and the Plaintiffs are therefore entitled to relief under 5 U.S.C. §§ 702, 706(2)(A), (C).

COUNT FOUR:

VIOLATION OF THE ADMINISTRATIVE PROCEDURE ACT—FAILURE TO PROVIDE INTERESTED PERSONS A SUFFICIENT OPPORTUNITY TO MEANINGFULLY PARTICIPATE IN THE RULEMAKING

71. Plaintiffs incorporate by reference the allegations of the preceding paragraphs.

72. The Administrative Procedure Act provides that when an agency promulgates a rule it "shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation." 5 U.S.C. § 553(c). This requirement compels an agency to set forth in an NPRM the most critical factual material and reasoning on which it relied to formulate proposed regulations.

73. The NPRM for the Rule did not fairly apprise the public of the basis and rationale for the amendments to Section 4.5. Among other things, it provided no rationale whatsoever for the inclusion of swaps within the trading threshold or the determination to re-establish the trading threshold at five percent. Additionally, its failure to assess in any way the Rule's costs and benefits under the statutory standards of Section 19(a) deprived the public of a reasonable opportunity to evaluate and comment upon the Commission's assessment and justification of the Rule pursuant to those statutorily-mandated analyses.

74. The NPRM also did not give fair notice of various aspects of the final Rule. The Commission did not give any advance notice of the seven-factor test for the marketing threshold set forth in the rule release, despite commenters' express requests for an opportunity to comment on any such factors. The determination of the Commission to adopt the Rule prior to further defining the term swap, and prior to establishing other relevant regulatory provisions, including those to be determined in the proposed harmonization rulemaking, also effectively deprived the public of its ability to comment on the Rule, as commenters were unable to make crucial determinations regarding the actual operation and effect of the proposed regulatory regime.

75. Plaintiffs are therefore entitled to relief under 5 U.S.C. §§ 702, 706(2)(D).

COUNT FIVE:

VIOLATION OF THE COMMODITY EXCHANGE ACT AND ADMINISTRATIVE PROCEDURE ACT—ARBITRARY AND CAPRICIOUS AGENCY ACTION IN REQUIRING FORM CPO-PQR

76. Plaintiffs incorporate by reference the allegations of the preceding paragraphs.

77. In adopting the reporting requirements set forth in Section 4.27 of the Rule, the Commission failed to satisfy its responsibilities under the Administrative Procedure Act to articulate a rational connection between the facts it found and the decisions it made, and to consider and respond to significant comments in the record. The Commission also failed to engage in the analysis of the costs and benefits of its action required by Section 19(a) of the CEA.

78. The Commission failed to provide an adequate explanation for requiring these reports in light of the significant disclosures that are already made pursuant to federal securities laws and the different risk profile presented by investment companies.

79. Adoption of these requirements of the Rule was arbitrary, capricious, and otherwise not in accordance with law, and the Plaintiffs are therefore entitled to relief under 5 U.S.C. §§ 702, 706(2)(A), (C).

COUNT SIX:

CLAIM FOR INJUNCTIVE RELIEF

80. Plaintiffs incorporate by reference the allegations of the preceding paragraphs.

81. Plaintiffs' members will be irreparably injured by the Rule once it is effective. The Rule will impose myriad compliance costs, including retaining counsel, upgrading systems, hiring additional compliance professionals, satisfying burdensome registration requirements, preparing and distributing required disclosure documents, and establishing controls to assure compliance with trading restrictions. These injuries will be redressed only if this Court declares the Rule's amendments to Sections 4.5 and 4.27 and related provisions unlawful and enjoins the CFTC from implementing those amendments.

82. An injunction would serve the public interest by averting harm to the efficiency and liquidity of the commodity markets, to the operation of registered investment companies, and to the interests of shareholders who would be harmed by the disruption of investment companies' operations, by the imposition of additional compliance costs, and by the loss of liquidity and the unwarranted deterrence of beneficial investment strategies. The Commission itself noted, in 2003, that lessening the burdens of dual registration would "encourage and facilitate participation in the commodity interest markets by additional collective investment vehicles . . . with the added benefit to all market participants of increased liquidity." 2003 Proposing Release at 12,625. Re-imposing those barriers to participation will have the opposite

effect. It is in the public interest to avoid those burdens, particularly when the benefits of registration are scant or non-existent given existing regulation.

83. These concerns outweigh any interest identified by the CFTC in issuing the Rule.

84. Plaintiffs are therefore entitled to injunctive relief under 5 U.S.C. § 702.

PRAYER FOR RELIEF

85. WHEREFORE, Plaintiffs pray for an order and judgment:

a. Declaring that the Rule's amendments to Sections 4.5 and 4.27 and related provisions were promulgated by the CFTC without statutory authority within the meaning of 5 U.S.C. § 706(2)(C); were not promulgated with procedures required by law within the meaning of 5 U.S.C. § 706(2)(D); and are arbitrary and capricious within the meaning of 5 U.S.C. § 706(2)(A);

b. Vacating and setting aside the Rule's amendments to Sections 4.5 and 4.27 and related provisions;

c. Enjoining the CFTC and all its officers, employees, and agents from implementing, applying, or taking any action whatsoever under the Rule's amendments to Sections 4.5 and 4.27 and related provisions;

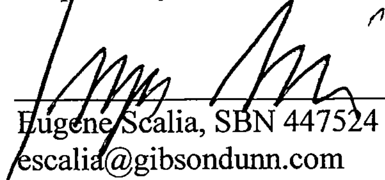
d. Issuing all process necessary and appropriate to postpone the effective date of the Rule's amendments to Sections 4.5 and 4.27 and related provisions and to maintain the status quo pending the conclusion of this case;

e. Awarding Plaintiffs their reasonable costs, including attorneys' fees, incurred in bringing this action; and

f. Granting such other and further relief as this Court deems just and proper.

Dated: April 17, 2012

Respectfully submitted,



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