IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

INVESTMENT COMPANY INSTITUTE, CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, Plaintiffs, v. UNITED STATES COMMODITY FUTURES TRADING COMMISSION, Defendant.	Case No. 1:12-cv-00612 (BAH)

DEFENDANT COMMODITY FUTURES TRADING COMMISSION'S CROSS-MOTION FOR SUMMARY JUDGMENT, OPPOSITION TO PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT, AND MOTION TO DISMISS IN PART

Pursuant to this Court's May 22, 2012 Minute Order, Defendant Commodity Futures Trading Commission files its Cross-Motion for Summary Judgment and Opposition to Plaintiffs' Motion for Summary Judgment, and Motion to Dismiss in Part. A memorandum of points and authorities is attached.

Dated: June 18, 2012

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MEMORANDUM OF THE COMMODITY FUTURES TRADING COMMISSION IN SUPPORT OF ITS CROSS-MOTION FOR SUMMARY JUDGMENT, IN OPPOSITION TO PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT, AND IN SUPPORT OF ITS MOTION TO DISMISS IN PART

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OVERVIEW

During the 2000s, the federal government implemented a broad policy of deregulation as a means of bolstering the financial services sector, including especially the markets in complex derivative instruments. This policy failed when, in 2007-2008, the country experienced a financial crisis caused, in significant part, by regulators' lack of visibility into those markets. This case concerns a rule promulgated by the Commodity Futures Trading Commission ("CFTC" or "Commission") in the aftermath of the crisis to regain some visibility into those markets, and the resulting obligation of certain entities that actively trade these instruments to file a registration statement and report to the CFTC certain financial data that is not currently available from any other source. These entities are "commodity pool operators" ("CPOs") as that term is defined by the Commodity Exchange Act ("CEA"). *See* 7 U.S.C. § 1a(11)(A). The CEA provides that all CPOs must register with the CFTC, *id.* § 6m(1), and file such reports as the Commission may prescribe, *id.* § 6n(3)(A).

The CEA also authorizes the Commission to modify the definition of "CPO" to include or exclude entities, to the extent such inclusions or exclusions will effectuate the purposes of the statute. *Id.* § 1a(11)(B). Plaintiffs in this case are two business associations claiming to represent a subset of statutory CPOs who also must register with the Securities and Exchange Commission ("SEC") pursuant to the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1, *et seq.*, because they trade in securities as well as derivatives. In 2003, as part of the government's policy of deregulation, the CFTC issued an exclusion for those SEC-registered investment companies ("RICs"), relieving them of most CFTC oversight. Additional Registration & Regulatory Relief for CPOs, 68 Fed. Reg. 47,221 (Aug. 8, 2003) ("2003 Rule").

The period since 2003 has, however, been a time of upheaval in the financial sector, and

in the derivatives markets in particular, due to the 2007-2008 financial crisis. In 2010, Congress responded to the crisis by passing the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (the "Dodd-Frank" Act). In Dodd-Frank, Congress issued multiple statutory commands charging the CFTC with the task of illuminating previously dark markets in the complex derivative instruments at the heart of the crisis known as "swaps." *See, e.g.*, *id.* §§ 721(a)(5)-(6) & (21), 722(a), 124 Stat. at 1659-60, 1666-69, 1672. As detailed below and in the rulemaking documents at issue, these historical and legislative events irrevocably transformed the premises on which the 2003 Rule had been based.

As part of Congress' mandate to the CFTC, the Dodd-Frank Act amended the statutory definition of "commodity pool operator" to include entities that trade in "swaps." *Id.* § 721(a)(6), 124 Stat. at 1659-60. Thus, the statutory definition from which the CFTC in 2003 excluded RICs no longer exists. During the rulemaking process at issue here, Plaintiff the U.S. Chamber of Commerce ("Chamber") admitted in a comment letter that this "major change" by itself "necessitate[d] a complete overhaul" of the relevant regulations. Letter from David T. Hirschmann (Apr. 12, 2011) ("Hirschmann Ltr.") at 5.[1]

Another critical development in recent years is that trading by RICs in derivatives including swaps has exploded to proportions far beyond anything contemplated by the SEC's governing statutes. As the SEC Chair noted in a statement relied upon by the CFTC in this rulemaking, "when the Investment Company Act was adopted, derivatives as we now know them did not exist." Mary Schapiro, Opening Statement at SEC Open Meeting (Aug. 31, 2011) ("Schapiro Statement"). "As a result, [mutual] fund investments in derivatives are not always

[1] Documents in the administrative record are available at http://www.cftc.gov/LawRegulation/RulemakingRecords/CPOCTARecords/index.htm.

wholly captured by statutory limitations and requirements," and "[t]he controls in place" concerning mutual fund RICs "can lose their effectiveness[.]" *Id.* Compounding these concerns, Congress and the Commission learned beginning in 2010 that certain entities, RICs in name only, were operating and marketing to U.S. customers investments in offshore derivative investment vehicles indistinguishable from commodity pools, but for their lack of CFTC oversight. Letter from Sens. C. Levin & T. Coburn to Internal Revenue Serv. (Dec. 20, 2011) at 3 ("Levin-Coburn Ltr."); Petition of the NFA to Amend Rule 4.5 (Aug. 18, 2010) ("NFA Pet.").

On the basis of these developments and concerns, the CFTC undertook an extensive administrative review beginning in 2010 shortly after Dodd-Frank and, in February 2012, voted 4-1 to eliminate the 2003 blanket RIC exclusion. *See* CPOs & CTAs: Compliance Obligations, 77 Fed. Reg. 11,252 (Feb. 24, 2012) (the "Final Rule"), *as corrected due to Fed. Reg. errors in its original publication*, 77 Fed. Reg. 17,328 (Mar. 26, 2012). In rescinding the blanket exclusion, the CFTC reasonably determined that requiring RICs that engage in significant commodity trading activity to register and report certain information about their investments will enhance the Commission's oversight of the derivatives markets and its ability to monitor and combat systemic risks. At the same time, however, the Commission recognized that registration and reporting would impose some burdens, and it therefore went to great lengths to minimize those burdens wherever it was reasonably possible to do so consistent with its regulatory objectives.

Plaintiffs in this case urge the Court to overturn those judgments and to restore, through a sprawling injunction, a deregulatory initiative undertaken in 2003 as part of a broader era of financial deregulation that proved calamitous. In doing so, they minimize or ignore central components of the CFTC's reasoning; downplay the significance of the financial crisis and

Dodd-Frank; advocate exacting legal standards that have no basis in the applicable law; and seek to preempt components of the administrative process that are still ongoing. This Court should decline Plaintiffs' demand to upend the CFTC's rulemaking in an area central to the CFTC's oversight of the derivatives markets and of critical importance to the national economy. As explained below, the CFTC is entitled to judgment as a matter of law on all of Plaintiffs' claims that are not otherwise subject to dismissal.

BACKGROUND

I. The Derivatives Markets and the Commodity Exchange Act

A. CFTC Jurisdiction and the CEA Definition of "Commodity Pool Operator"

The CEA establishes that the CFTC is the exclusive federal regulator of many derivative instruments and markets. *See* 7 U.S.C. § 2(a)(1). A "derivative" is an instrument whose value depends on (*i.e.*, is "derived" from) the price of some "underlying" asset.[2] Derivatives are traded on exchanges or, especially before Dodd-Frank, bilaterally in "over-the-counter" (or "OTC") transactions. Today, the CFTC's jurisdiction includes futures, options, and swaps, and the markets for those investment products. *See* 7 U.S.C. § 2(a)(1); Dodd-Frank § 722(a), 124 Stat. at 1672.

The derivatives markets are distinct and serve different economic functions from securities markets. "In establishing the [CFTC] in 1974, Congress decided that the[se] very different functions," *i.e.*, "securities markets [for] capital formation and investment[,] and futures markets [for] risk-shifting and speculation[,] could best be overseen by separate regulatory agencies." Chairperson Brooksley Born, *Regulatory Responses to Risks in the OTC Derivatives*

[2] CFTC Glossary, A Guide to the Language of the Futures Industry, http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_d.

Market, Remarks to the ABA Section of Bus. Law (Nov. 13, 1998) ("Born Remarks").[3] The CEA, therefore, contains detailed provisions delineating the respective jurisdictions of the CFTC and SEC. *See, e.g.*, 7 U.S.C. § 2(a)(1)(C)-(D). In general, "the SEC is the functional regulator of the securities and securities option markets, and the CFTC is the functional regulator of most other derivatives markets." Born Remarks, *supra*; *see also* Dodd-Frank, title VII, 124 Stat at 1641-1802. While the SEC's mission is focused on ensuring a "transparent capital market that facilitates the capital formation so important to our nation's economy," SEC, *The Investor's Advocate*, http://www.sec.gov/about/whatwedo.shtml, the CFTC's mission is, among other things, "to protect market users and the public from fraud, manipulation, abusive practices and systemic risk related to derivatives that are subject to the Commodity Exchange Act," CFTC, *Mission & Responsibilities*, http://www.cftc.gov/ About/MissionResponsibilities/index.htm.

The CEA defines the term "commodity" to encompass a large swath of goods and articles, including "all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1a(9).[4] The CEA also broadly defines the term "commodity pool operator" to include "any" person or entity operating a business in which they solicit or accept value "for the purpose of trading in commodity interests, including *any*" commodity future, option, swap, or certain other specified types of instruments. *Id*. § 1a(11)(A) (emphasis added). Unless subject to an exemption, all CPOs must register with the CFTC. *Id*. § 6m(1).

[3] Available at http://www.cftc.gov/opa/speeches/opaborn-40.htm.

[4] For example, the statute lists various agricultural commodities, 7 U.S.C. § 1a(9) (*e.g.*, wheat, cotton, rice, livestock, soybeans, butter, eggs, and wool), while the "all services, rights, and interests" clause encompasses contracts based on, *inter alia*, financial instruments, indices, currencies, energy, and precious metals. *See Chicago Mercantile Exch. v. SEC*, 883 F.2d 537, 542 (7th Cir. 1989); *Salomon Forex, Inc. v. Tauber*, 795 F. Supp. 768, 771 (E.D. Va. 1992), *aff'd*, 8 F.3d 966 (4th Cir. 1993); *see also* 7 U.S.C. § 1a(10)(A)(i).

The statute sets no minimum trading threshold for qualification as a CPO. As a result, a pooled investment vehicle operator is a statutory CPO if it trades even a single commodity, option, or swap. *See id*. § 1a(11)(A). By the same token, the statute presumes that a CPO may conduct trading activity in markets outside the CFTC's jurisdiction, such as securities markets. In this way, the CEA contemplates dual registration by some entities with the CFTC and SEC.

B. Regulatory History: The CFTC's Discretion to Include and Exclude

While the CEA defines "commodity pool operator," it also authorizes the CFTC to include or exclude any entity as a CPO if, in the Commission's judgment, such inclusion or exclusion "will effectuate the purpose of th[e] [CEA]." 7 U.S.C. § 1a(11)(B). This discretionary authority "was intended to be exercised 'to exempt from registration those persons who otherwise meet the criteria for registration * * * if, in the opinion of the Commission, there is no substantial public interest to be served by the registration.'" Final Rule, 77 Fed. Reg. at 11,253 (quoting H.R. Rep. No. 93-975, 93d Cong. 2d Sess. (1974), p. 20). The CFTC has exercised this authority over the years to expand and contract exclusions in response to new information and changing circumstances.

1. The 1985 Exclusion

After Congress enacted the CEA in 1974, the Commission handled case-by-case requests by investment vehicles for exclusion from the definition of CPO. CPO & CTA: Exemption from Registration, 49 Fed. Reg. 4778, 4779 (Notice of Proposed Rulemaking Feb. 8, 1984) ("1984 NPRM"). Entities receiving individual exclusions typically used commodities for hedging risks rather than speculation; would commit only a small percentage of assets to commodity trading; would not be promoted as a commodity pool investment; would disclose to investors the purpose and limitations of their commodity trading; and were subject to extensive federal or state regulation. *Id*.

In 1983, the Senate Agriculture Committee, which oversees the CFTC, proposed that the Commission issue a rule to establish certain narrow exclusion criteria. *See id*. at 4780. These included precursors to the criteria contained in the Final Rule at issue in this case, such as a 5-percent limitation on the amount of assets the RIC may use for commodity investment without registering, and a restriction on marketing the fund as a vehicle for commodity investments. *Id*. The Committee explained that a limited exclusion along these lines was "the intent of the definition of the term 'commodity pool operator,' as that term is defined in the [CEA]." *Id*.

In 1985, the CFTC adopted a narrow exclusion from the definition of "CPO" that was based on, though not identical to, the Committee's proposal. *See* CPOs; Exclusion for Certain Otherwise Regulated Persons, 50 Fed. Reg. 15,868, 15,883 (Apr. 23, 1985) ("1985 Rule"); 17 C.F.R. § 4.5 (1985). The 1985 Rule permitted RICs to use derivatives primarily for hedging purposes, without CFTC registration, provided, among other things, that the RIC commit no more than 5 percent of its assets to margin or premiums for those derivatives. *Id*. "Margin," in this context, is akin to collateral that a derivatives trader must post in order to cover potential downside price movement. The CFTC explained that the 5-percent threshold "suggested by the [Agriculture] Committee" would provide a "bright line to distinguish between entities," and would allow significant flexibility. *Id*. at 15,878 & n.64 (noting by way of example that 5-percent threshold would permit a RIC "to enter into [futures] contracts with a market value of" approximately 2 times the full "fair market value of its [the RIC's] assets").

2. The Rise of "Swaps" and the Commodity Futures Modernization Act of 2000

During the 1980s and 1990s, a new class of derivative became pervasive – the "swap" contract. A "swap," in general, is an agreement between two or more parties to exchange sequences of cash flows over a period of time. Robert W. Kolb & James A. Overdahl, *Futures,*

Options, and Swaps, at 5-6 (5th ed. 2007). The payments are based on the value of an underlying asset, such as an interest rate, currency, security, corporate bond, or other credit instrument. *Id.; see also* Norman M. Feder, *Deconstructing Over-the-Counter Derivatives*, 2002 Colum. Bus. L. Rev. 677, 701-16 (2002).[5]

Certain concepts generally applicable to derivatives are also relevant to swaps. For example, the "notional value" of a swap or other derivative refers to the hypothetical underlying quantity upon which payment obligations are computed. *See* 17 C.F.R. § 4.5(c)(2)(iii)(B)(1). For example, where one "leg" of a swap is based on a floating interest rate, the payment is calculated by, among other steps, multiplying the rate by the notional value.[6] The full "notional value" does not change hands, but, depending on what sums are due under the opposite leg, the counterparty may profit as though the full notional value were given as a loan. This is the concept of "leverage" – the use of a financial instrument to increase the potential return on an investment. The special danger of derivatives comes, in part, from the downside of leverage – that a sum may come due far in excess of the amount invested. This happens, for example, when a party to a credit default swap, in which the underlying value is based on the credit status of a "reference entity," becomes obligated to pay the full notional value after the reference entity files for bankruptcy. *See* Daniel Hemel, *Comment: Empty Creditors & Debt Exchanges*, 27 Yale J. on Reg. 159, 159-61 (2010).

The leveraged nature of derivatives means that, in a pooled investment vehicle, a

[5] The Dodd-Frank Act contains a broader and more detailed definition of "swap." Dodd-Frank § 721(a)(21), 124 Stat. at 1666-69.

[6] In a swap, the parties trade two "legs," *i.e.*, a payment from one party to the other at set intervals over the life of the contract. For example, in an interest rate swap, one party may agree to pay the other a fixed interest rate over a notional value while the second party may agree to pay a variable interest rate over the same notional value. In this example, the fixed interest rate and the variable interest rate are the swap's two "legs."

relatively small percentage of asset value invested in derivatives can have a dramatic impact on profits, losses, and the financial stability of the fund. The SEC Chair, in a statement referenced in the Final Rule, observed that this characteristic of derivatives can overwhelm the controls in place at RICs:

> "***The controls in place to address fund management in traditional securities can lose their effectiveness when applied to derivatives***. This is particularly the case because a relatively small investment in a derivative instrument can expose a fund to potentially substantial gain or loss – or outsized exposure to an individual counterparty."

Final Rule, 77 Fed. Reg. at 11,255 (quoting the Schapiro Statement) (emphasis added).

Swaps, for most of their history, were typically executed off-exchange in bilateral (OTC) transactions. As the use of these instruments became widespread in the 1990s, debate arose over whether to regulate swaps like other derivatives. *See, e.g.*, Born Remarks, *supra* ("This lack of basic information about the positions held by OTC derivatives users and about the nature and extent of their exposures potentially allows them to take positions that may threaten our regulated markets or, indeed, our economy without the knowledge of any federal regulatory authority.").

Proponents of deregulation prevailed. In December 2000, Congress passed the Commodity Futures Modernization Act, Pub. L. No. 106-554, 114 Stat. 2763 (2000) ("CFMA"), which barred both the CFTC and SEC from regulating most swaps, including the over-the-counter swaps markets. *See* 7 U.S.C. § 2(g) (2002); CFMA §§ 302-303, 114 Stat. at 2763. Congress stated that its intent under the CFMA was, among other things, "to streamline and eliminate unnecessary regulation," to "enhance the competitive position of United States financial institutions and financial markets," and to "reduce systemic risk." CFMA § 2, 124 Stat. at 2763A-366. The CFMA left the markets for swaps and other OTC derivatives essentially

unregulated and unmonitored – effectively dark – in most respects.

3. The 2003 Deregulatory Rules

In 2003, the CFTC enacted a set of rules intended to be "consistent with the purpose and intent of the CFMA" by, among other things, vastly broadening the Rule 4.5 exclusion by eliminating "any trading criteria and corresponding disclosure requirement." 2003 Rule, 68 Fed. Reg. at 47,222. The Commission eliminated the 5 percent ceiling for derivatives trading by RICs without CFTC registration, along with any requirement that an excluded entity trade commodities only for hedging purposes. It explained that this was appropriate in "the current [2003] investment environment" to promote "flexibility" for participants in derivatives transactions and to "remov[e] barriers to participation." *Id*. at 47,223, 47,230. The Commission stated that this would promote "liquidity," have "no effect . . . on the financial integrity . . . of the commodity futures and options markets," and that reduced oversight would actually promote better "risk management." *Id*. at 47,230. As Plaintiffs note, the 2003 Commission identified "no countervailing cost" to this deregulation. (Mem. 33-34.)[7]

Following the 2003 deregulation, RICs could engage in unlimited derivatives trading, for any purpose, without CFTC registration, including unlimited trading in swaps. The swaps issue was given no explicit consideration, because the CFMA had placed those markets outside of the CFTC's jurisdiction. Many entities invested heavily in commodity derivatives, including swaps, with limited regulatory oversight. *See* Final Rule, 77 Fed. Reg. at 11,255 n.35 (noting "'dramatic growth in the volume and complexity of derivatives investments over the past two decades, and [mutual] funds' increased use of derivatives'") (quoting SEC Release, Use of

[7] References to "Mem." are to Plaintiffs' Memorandum of Points & Authorities in Support of Motion for Summary Judgment filed May 18, 2012. (Doc. # 8.)

Derivatives by Investment Companies Under the Investment Company Act of 1940, 76 Fed. Reg. 55,237, 55,238 (Sept. 7, 2011) ("SEC Release")). The SEC has stated that "complete data concerning the nature of derivatives activities of [RICs] is unavailable." SEC Release, 76 Fed. Reg. at 55,238 n.7.

4. The Financial Crisis Prompts Congress to Grant the CFTC Jurisdiction over Swaps.

The financial crisis of 2007-2008 has widely been attributed in significant part to the unchecked growth in the 2000s of dark, unregulated markets in over-the-counter derivatives including swaps. *See, e.g.*, S. Rep. No. 111-176, at 29 (2010) (stating that these instruments were a "major contributor" to the crisis). In response, Congress passed Dodd-Frank in July 2010, which, among its most important provisions, gave the CFTC primary jurisdiction over most swaps. *See generally* Dodd-Frank, title VII, 124 Stat. at 1641-1802; *id*. § 722(a); 7 U.S.C. § 2(a)(1)(A); *see also id*. § 1a(47). Title VII of Dodd-Frank also "amended the statutory definition of the terms 'commodity pool operator' and 'commodity pool' to include those entities that trade swaps." Final Rule, 77 Fed. Reg. at 11,258 & n.71 (citing 7 U.S.C. §§ 1a(10), 1a(11)).

II. The 2010-2012 Rulemaking Process

A. The NFA Petition Concerning Offshore Commodity Trading

Shortly after the passage of Dodd-Frank, the National Futures Association ("NFA"), the primary self-regulatory organization ("SRO") in the derivatives industry, filed a petition for rulemaking with the CFTC. In its petition, NFA alerted the CFTC that certain mutual funds were exploiting SEC regulations and IRS letter rulings to market "managed futures strateg[ies]" to U.S. investors, executed through subsidiaries neither registered with the CFTC nor the SEC, and "not subject to the Investment Company Act of 1940's customer protection regime." NFA Pet. at 3-4, 8-9. Under this technique, a parent company would register with the SEC as a RIC and

would hold ordinary assets such as money market instruments, but would use those assets as collateral for derivatives trading by its subsidiary. *Id*. at 4. The investments would be highly leveraged to achieve derivatives exposure equal to the full net value of the fund. *Id*. The unregistered subsidiary would invest, for example, in "exchange traded futures and options contracts, forward contracts, swaps, and other over the counter derivatives and fixed income securities," yet "the subsidiaries' daily operations, including their actual derivatives positions (including the positions' leverage amounts) and fees charged" would be allowed to remain "not entirely transparent." *Id*. at 9. Investments in the parent RIC would then be "marketed to consumers, including retail investors, as commodity futures investments." *Id*. at 3. According to NFA, exemplar "offering material omit[ted] substantial disclosures" to investors "that would otherwise be mandated by" CFTC regulations. *Id*. at 8. NFA urged the CFTC to "amend Regulation 4.5(c) to restore operating restrictions on registered investment companies that are substantially similar to those in effect prior to 2003." *Id*. at 1.

In December 2011, the Chairman and Ranking Minority Member of the Senate Permanent Subcommittee on Investigations wrote a letter to the IRS that is part of the CFTC rulemaking record in this matter, reporting that as many as 72 mutual funds were employing the above-method of circumventing federal regulation and taxation through "controlled foreign corporations (CFCs)," often based in the Cayman Islands, and then targeting derivatives investments at U.S. investors: "That the Cayman CFCs are empty shells designed to allow U.S. mutual funds to create commodity related investment portfolios, run by their own U.S. employees, is openly acknowledged." Levin-Coburn Ltr. at 3. The Subcommittee confirmed, based on its investigation, that some of these funds were RICs in name only, offering "investors leveraged exposure to their commodity related investments," and that one fund "reported having

over $22 billion invested in commodity related assets with approximately 900,000 investors, 75% of which [we]re individuals." *Id*.

B. The Notice and Comment Process

In February 2011, the CFTC issued a Notice of Proposed Rulemaking ("NPRM"), proposing to amend Rule 4.5 to narrow the exclusion for RICs and to rescind or modify other exclusions and exceptions, including an exclusion for hedge funds. CPO & CTA: Amendments to Compliance Obligations, 76 Fed. Reg. 7976 (Feb. 11, 2011) ("NPRM"). The Commission explained that recent economic events and the passage of Dodd-Frank had changed the premises underlying existing exemptions and exclusions, and caused the Commission to reconsider the appropriate levels of regulation and monitoring. *Id*. at 7977. An extensive rulemaking and public comment process ensued. The CFTC received more than 60 comments, including some from U.S. Senators, and others from members of the public arguing strongly in favor of the proposal. *See, e.g.*, Letter from D. Sawyier (Sidley Austin LLP) (Apr. 11, 2011) at 8 ("We see no reason that commodity pools should not be regulated by the Commission, irrespective of whether the SEC permits such pools also to register as investment companies."). On July 6, 2011, the CFTC held a day-long "Roundtable" on the proposal, in which Plaintiffs participated. *See* Roundtable Tr. at 3-4. During the administrative process, which extended for more than a year before the final vote, the CFTC repeatedly urged all interested parties to submit any relevant data for the Commission's consideration. *See, e.g.*, NPRM, 76 Fed. Reg. at 7988; Roundtable Tr. 99-100. The Commission reviewed and considered all comments, met with interested parties, and considered all available evidence before voting 4-1 to approve the Final Rule.

C. The Final Rule

As relevant here, the Final Rule: (1) amends Rule 4.5, 17 C.F.R § 4.5, to narrow the CPO definitional exclusion for RICs to approximately the scope of the exclusion as it existed before

the 2003 deregulation, and (2) modifies Rule 4.27, 17 C.F.R. § 4.27, to require reporting of financial information on "Form CPO-PQR." 77 Fed. Reg. at 11,253-54.

Under amended Rule 4.5, a RIC may qualify for exclusion if, *inter alia*, its trading in commodity futures, commodity options, or swaps does not exceed one of two thresholds: (1) 5 percent or less of its portfolio liquidation value is used for initial margin and premiums; or (2) the net notional value of all such investments does not exceed 100 percent of the liquidation value of the pool's portfolio. *Id*. at 11,283. With respect to either threshold, a RIC may *exclude* all bona fide hedging transactions from the calculation. *See id*. at 11,256. In light of the alternative net notional test and the exclusion for bona fide hedging transactions, the amended Rule 4.5 is more permissive than the 1985 Rule.

The Final Rule also prohibits a RIC claiming the Rule 4.5 exclusion from "marketing participations to the public as . . . a vehicle for trading in the commodity futures, commodity options, or swaps markets." *Id*. at 11,283. In response to comments from Plaintiff ICI and others requesting the Commission's views on what factors it would consider in enforcing this restriction, the Commission identified seven that "are indicative of marketing a [RIC] as a vehicle for investing in commodity futures, commodity options, or swaps." *Id*. at 11,258-59 & n.76 (listing (1) the name of the fund; (2) whether the fund's objective is tied to a commodity index; (3) whether the fund uses a CFC for derivatives trading; (4) whether the fund's marketing materials or disclosures reference derivatives; (5) whether the fund normally has a net short speculative exposure to any commodity; (6) whether futures, options, or swaps will be the fund's primary source of gains and losses; and (7) whether the fund is explicitly offering a managed futures strategy).

With respect to financial reporting, Rule 4.27 requires registered CPOs to file Form CPO-

PQR, which is appended to the Final Rule. The information reported on Form CPO-PQR is comparable to that required from hedge funds on "Form PF" – information concerning derivatives trading that RICs do not currently report to any regulator. *See* Final Rule, 77 Fed. Reg. at 11,253. Rule 4.27 establishes a system of three schedules – A, B, and C – by which the frequency and detail of reporting varies by the size of the CPO.[8] Schedule A must be filed at least annually by all CPOs and quarterly by large CPOs (at least $1.5 billion in assets under management). It requires demographic information about the pool and its service providers; whether it is a master or feeder fund; net income, change in asset value, and total subscriptions and redemptions; monthly rates of return; and any restrictions on redemptions or withdrawals. The same schedule is required of hedge funds dually registered with the SEC and CFTC. *Id*. at 11,267. Schedule B must be filed annually by mid-size CPOs (at least $150 million in assets under management) and quarterly by large CPOs, and requires information concerning percentage of assets devoted to different trading strategies; use of algorithms and high frequency trading; total borrowings; counterparty credit exposure; derivative trading and clearing mechanisms; the value of derivative positions; and total investments by investment type. Finally, Schedule C must be filed quarterly, by large CPOs only. It requires information on the geographical breakdown of investments; turnover rate; portfolio liquidity; amounts posted as security, collateral, and letters of credit; percentage of margin that may be rehypothecated; risk metrics; financing liquidity; investor liquidity; and duration of fixed income assets. The Commission provided detailed reasoning for requiring this information. *See* NPRM, 76 Fed.

[8] The Final Rule also contains related amendments that require registration and reporting by "commodity trading advisors" or "CTAs," but Plaintiffs have not stated any challenge to those provisions. Entities that are registered as CPOs need not register as CTAs as long as their commodity trading advice is limited to the pools they operate. 17 C.F.R. § 4.14(a)(4).

Reg. at 7980-82 (incorporated by reference at Final Rule, 77 Fed. Reg. at 11,254).

D. Other Compliance Obligations Are the Subject of Ongoing Rulemaking.

As a result of registration, and in addition to financial reporting, CPOs generally become subject to requirements under Part 4 of the CFTC's regulations concerning recordkeeping and risk disclosures to investors. However, some commenters in this rulemaking, including Plaintiff ICI, asserted that obligations flowing from CFTC registration needed further consideration in order to avoid conflict with certain SEC requirements for RICs. The Commission concluded that these concerns warranted additional notice-and-comment rulemaking devoted to harmonization. Final Rule, 77 Fed. Reg. at 11,259. Thus, concurrently with the Final Rule, the CFTC issued a notice of proposed rulemaking proposing to harmonize these areas of compliance. Harmonization of Compliance Obligations for RICs Required to Register as CPOs, 77 Fed. Reg. 11,345 (Feb. 24, 2012) ("Harmonization NPRM").[9] The Commission also suspended the obligation of RICs affected by the Rule 4.5 amendments to comply with these Part 4 regulations, pending the issuance of a final harmonization rule. Final Rule, 77 Fed. Reg. at 11,252. The Final Rule provides that entities required to register because of the Rule 4.5 amendments shall not be "subject to the Commission's recordkeeping, reporting, and disclosure requirements pursuant to part 4 of the Commission's regulations" until "60 days following the effectiveness of a final rule implementing the Commission's proposed harmonization effort." 77 Fed. Reg. at 11,252. Thus, the provisions challenged by Plaintiffs are final *only* with respect to registration

[9] The NPRM on Harmonization addresses the requirements in Rule 4.21 (delivery and acknowledgement requirements); Rule 4.22 (periodic account statements and financial reports); Rule 4.23 (maintenance of books and records); Rule 4.24 (cautionary statements and other disclosures); Rule 4.25(c)(2)-(5) (disclosures by pools in operation for less than 3 years); and Rule 4.26 (timing of disclosures to investors).

under Rule 4.5 and financial reporting under Rule 4.27. They are not final as to other areas.

STANDARD OF REVIEW

A court may set aside agency action under the Administrative Procedure Act ("APA") only when it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). This review is "deferential" and "presumes the validity of agency action." *WorldCom Inc. v. FCC*, 238 F.3d 449, 457-58 (D.C. Cir. 2001) (internal quotation marks omitted). The scope of review is "narrow," and the Court is not to "substitute its judgment for that of the agency." *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 513 (2009) (internal quotation marks omitted). The agency action must be upheld so long as the agency provides an explanation and there is a "rational connection between the facts found and the choice made." *Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin.*, 626 F.3d 84, 90 (D.C. Cir. 2010) (internal quotation marks omitted). If the agency meets the APA standard of review, it is entitled to summary judgment. *Genesis Health Ventures, Inc. v. Sebelius*, 798 F. Supp. 2d 170, 179 n.19 (D.D.C. 2011).

Plaintiffs seek to impose an additional requirement. They argue that before the CFTC can revise an existing regulation, the Commission must first demonstrate that the old rule is "inadequate." (Mem. 22.) They cite no authority for that requirement, and there is none. To the contrary, the Supreme Court has rejected subjecting regulatory change "to more searching review." *Fox Television Stations*, 556 U.S. at 514. An agency "need not demonstrate to a court's satisfaction that the reasons for the new policy are *better* than the reasons for the old one; it suffices that the new policy is permissible under the statute, that there are good reasons for it, and the agency *believes* it to be better, which the conscious change of course adequately indicates." *Id.* at 515.

SUMMARY OF ARGUMENT

Under the deferential APA standards, the Commission is entitled to judgment as a matter of law on Plaintiffs' challenges to Rules 4.5 and 4.27. And to the extent Plaintiffs are challenging compliance obligations that are subject to the ongoing harmonization rulemaking, those claims are unripe and should be dismissed.

1. Plaintiffs' claims proceed from the entirely false assertion that the CFTC has not identified problems in the derivatives markets or other reasons to justify revising the deregulatory scheme of 2003 by no longer categorically excluding RICs that are also commodity pool operators. The Final Rule is a sensible and prudent response to the central role of the unregulated, opaque derivatives markets in the financial crisis of 2007-2008 and Congress' charge to the CFTC to regulate the swaps market and guard against systemic risk. Because the Commission gave several valid reasons for narrowing the broad exclusion of RICs and returning, after only a brief interval, to oversight of RICs that engage in a significant amount of commodity trading activity, Plaintiffs' challenge to that policy change lacks merit.

2. Plaintiffs' challenges to the specific criteria that the Commission adopted for Rule 4.5 similarly fall short. First, the 5 percent threshold for triggering registration is a standard the Commission applied for nearly twenty years before the 2003 deregulation, and which the Commission explained continued to be appropriate, while neither Plaintiffs nor other commenters provided the Commission with data that supported a higher threshold. Moreover, to address concerns that the 5 percent threshold might be too restrictive in certain instances, the Commission provided an alternative "net notional value" test that permits exclusion from registration if the net notional value of the RIC's derivatives positions does not exceed 100 percent of the liquidation value of the pool's portfolio. The Commission's decision here was

surely reasonable.

Second, the inclusion of swaps in the threshold follows logically, if not inexorably, from Dodd-Frank, which assigned the CFTC to be the primary regulator of the swaps market. In the wake of the financial crisis and Dodd-Frank's concern about the unregulated nature of the swaps market, it would have been anomalous in the extreme for the Commission to ignore an entity's swaps trading in determining whether to exercise oversight.

Third, the Commission's decision to limit the hedging exception to bona fide hedges – that is, to transactions that hedge a risk arising from the entity's position in a cash market – was prudent and reasonable. The Commission had no obligation to offer *any* such exception and expressed concern that a broader "risk management" exception preferred by Plaintiffs would be difficult to cabin because objective criteria for marking the boundaries of such an exception are lacking. The APA requires no more.

Finally, the Commission did not violate the APA's notice-and-comment requirement by providing guidance on factors it would consider in determining compliance with the marketing restriction in Rule 4.5. The Commission's discussion of these factors is not a rule; rather, it is a statement of policy with respect to how the Commission will evaluate compliance with Rule 4.5. As such, the notice and comment requirement does not apply. In any event, the discussion is a logical outgrowth of the proposal, which asked for comments on how the marketing restriction could be narrowed.

3. Plaintiffs' challenge to Rule 4.27's financial reporting obligations likewise fails. The CFTC established a tiered approach to reporting information on Form CPO-PQR, under which the reporting obligations increase with the size of the commodity pool. This approach appropriately balances the burdens of reporting with the Commission's need for information

from entities that are operating in its jurisdictional markets. Plaintiffs do not specifically challenge any of the information requests, and their broad challenge to the Commission's need for the information is unavailing. The Commission explained at all stages of the rulemaking that the information it could receive without Form CPO-PQR was insufficient and that this information was not otherwise available. Plaintiffs provide no basis for disturbing the Commission's judgment on this matter, which goes to the core of the agency's responsibility to conduct effective oversight of the commodity derivatives markets and is thus entitled to substantial deference.

4. Plaintiffs' challenges to other compliance obligations, such as recordkeeping and disclosure, should be dismissed because they are unripe. Responding to commenters' concerns that these other compliance obligations would potentially conflict with SEC requirements, the Commission – consistent with its cost-mitigation approach – initiated a new rulemaking to harmonize the two regimes to the extent possible, and has suspended any obligation to comply with these additional obligations until further rulemaking is complete. Thus, Plaintiffs' complaints on this score are premature.

5. The Commission's consideration of the costs and benefits of its actions also was sufficient. The Commission identified several reasons why the SEC's regulation of securities markets does not address the concerns about commodity derivatives markets underlying the Final Rule, and considered all available information in the context of the prescribed statutory factors. Plaintiffs' vague accusation that the CFTC acted without obtaining "relevant market data" blinks reality. (Mem. 35.) The swaps markets have been dark. An agency need not refrain from action where data is unavailable or incomplete, particularly where, as here, the agency is exercising undisputed statutory authority that lies at the core of its mission. Despite the lack of substantial

quantitative data, the Commission here identified the relevant costs and benefits, and evaluated them in light of the five factors set out in CEA Section 15(a), 7 U.S.C. § 19(a)(2). In considering the costs, the Commission endeavored wherever practicable to reduce the burdens attendant to registration and reporting, making several changes from the proposal to minimize such burdens. The Commission's action was thus neither arbitrary nor capricious.

ARGUMENT

I. The CFTC Complied with All Aspects of the APA and CEA.

Nothing about the Commission's decision, after a short period of deregulation, to resume regulating RICs that engage in more than de minimis activity in the commodity derivatives markets, was arbitrary or capricious. The CFTC, therefore, is entitled to summary judgment.

A. The Final Rule Has a Reasoned Basis in the Record.

The Commission stated at least seven separate and compelling reasons for circumscribing the 2003 blanket exclusion of RICs from CFTC regulation. These include:

(1) **To "eliminate informational 'blind spots'" in derivatives markets.** Final Rule, 77 Fed. Reg. at 11,275; *see also id*. at 11,278 n.224, 11,279, 11,280, 11,281; NPRM, 76 Fed. Reg. at 7988.

(2) **To enable the CFTC to carry out its "more robust mandate" after Dodd-Frank "to manage systemic risk and ensure safe trading practices by entities involved in" the CFTC's markets, including swaps markets**. Final Rule, 77 Fed. Reg. at 11,275; *see also id*. at 11,277, 11,279; NPRM, 76 Fed. Reg. at 7976, 7977, 7978.

(3) **To "better understand who is operating in derivatives markets" and the "interconnectedness of all market participants" – a critical informational need if the CFTC is to carry out its mandate to "assess potential threats to the soundness of derivatives markets and thus the financial system of the United States."** Final Rule, 77 Fed. Reg. at 11,280; *see also id.* at 11,281; NPRM, 76 Fed. Reg. at 7978, 7988.

(4) **To enable the CFTC to perform its duties as a member of the new Financial Stability Oversight Council ("FSOC") established in Dodd-Frank.** Final Rule, 77 Fed. Reg. at 11,252-53; *see also id*. at 11,281; NPRM, 76 Fed. Reg. at 7977, 7978.

(5) **To respond to Congress' amendment in Dodd-Frank of the definition of "commodity pool operator" to include investment vehicles participating in even a**

single swap. Final Rule, 77 Fed. Reg. at 11,258; *see also id*. at 11,260; NPRM, 76 Fed. Reg. at 7986.

(6) **To address new information indicating that RICs were operating as de facto unregulated commodity pools.** Final Rule, 76 Fed. Reg. at 11,254, 11,258-59; NPRM, 76 Fed. Reg. at 7983.

(7) **To ensure that operators of all commodity pools, including swap-trading entities newly brought within the statutory definition, meet minimum standards of competency.** Final Rule, 77 Fed. Reg. at 11,254, 11,277.

Some of these aims pertain to registration, while others pertain also to financial reporting. In the Final Rule, the Commission articulated compelling reasons for each amendment, based on transformed circumstances following the financial crisis and Dodd-Frank, and on the basis of an extensive rulemaking record.

B. Plaintiffs' Claim of "No Problems" in the Derivatives Markets Since 2003 Is Fanciful.

An agency is entitled to change its view of what is in the public interest, based on changed circumstances, policy judgments, or both. *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 57; *Am. Farm Bureau Fed'n v. EPA*, 559 F.3d 512, 521-522 (D.C. Cir. 2009). In Plaintiff Chamber's *own words*, to say that circumstances have changed since 2003 would be a "gross understatement." *See* Summary Statement before the CFTC Roundtable, at 1 (July 6, 2011).

The gravamen of Plaintiffs' case is that, in their opinion, the Commission executed a "summary reversal" of the 2003 amendments when it had "identified no problems or abuses since 2003 that justified regulation." (Mem. 1.) There is little doubt, of course, that the world would be better off if this were so and the derivatives markets had experienced "no problems" between 2003 and 2012 that warranted increased monitoring. "If wishes were horses, beggars might ride." *United States v. Nagib*, 939 F. Supp. 653, 654 (E.D. Wis. 1996). While Plaintiffs profess bewilderment that the CFTC in 2012 would not adhere to the policy judgments

underlying the 2003 deregulation rules (Mem. 1, 32-34), they virtually ignore the two sea-changing events of modern financial history that the Commission could not ignore – the 2007-2008 financial crisis and Congress' passage of Dodd-Frank in 2010. They likewise ignore portions of the Final Rule release and NPRM that explain the connection between those events and the Final Rule, an omission underscoring the weakness of their claims of "arbitrary and capricious" rulemaking. *See, e.g.*, 77 Fed. Reg. at 11,275 ("[W]hile the Commission must execute this mandate, there currently is no source of reliable information regarding the general use of derivatives by registered investment companies. The Commission, therefore, is adopting a new registration and data collection regime for CPOs . . . ."); NPRM, 76 Fed. Reg. at 7977 ("Following the recent economic turmoil, and consistent with the tenor of the provisions of the Dodd-Frank Act, the Commission has reconsidered the level of regulation that it believes is appropriate with respect to entities participating in the commodity futures and derivatives markets."). Far from addressing "no problem," the CFTC's actions were sensible and prudent, and this Court must defer to the Commission's reasonable judgment. *Am. Farm Bureau Fed'n*, 559 F.3d at 521-22.

The 2003 amendments to which Plaintiffs would have this Court revert were premised expressly on implementing the 2000 CFMA's deregulatory agenda of "flexibility," promoting "liquidity" – *i.e.*, higher levels of investment activity – and "removing barriers to participation" in derivatives markets. 2003 Rule, 68 Fed. Reg. at 47,230. The 2003 Commission deemed the blanket exclusion of RICs from CFTC oversight appropriate in light of "the current investment environment." *Id*. at 47,223. At that time, the Commission anticipated no impact from deregulation "on the financial integrity . . . of the commodity futures and options markets," *id*. at 47,230, and in fact, as Plaintiffs note, the Commission foresaw no countervailing costs at all.

(Mem. 33-34.) Consistent with the deregulatory philosophy underlying the CFMA, the 2003 Commission, obviously without the benefit of current hindsight, believed that eliminating oversight actually would *enhance* risk management by market participants. *Id*. In 2012, those are judgments with which the current Commission simply could not agree. *See* 77 Fed. Reg. at 11,253 ("The sources of risk delineated in the Dodd-Frank Act with respect to private funds are also presented by commodity pools.").

Plaintiffs virtually ignore that between 2003 and 2012 intervened the "unraveling of this country's financial sector," S. Rep. No. 111-176 at 29 (2010), culminating in a "crisis that nearly crippled the U.S. economy beginning in 2008," *id*. at 2. It is well understood, at least by lawmakers, that "a major contributor to the financial crisis was the unregulated over-the-counter ('OTC') derivatives market," *i.e.*, the massive market in bilateral swap transactions. *Id*. at 29; *see also, e.g., id*. at 30 ("Lack of transparency in the massive OTC market intensified systemic fears during the crisis about interrelated derivatives exposures from counterparty risk."); 156 CONG. REC. S3604-05 (May 12, 2010) (Statement of Sen. Shelby) ("[T]here is no debate that the lack of transparency in the OTC derivatives market was a contributing factor to the financial debacle."); *Final Report of the Nat'l Comm'n on the Causes of the Fin. and Econ. Crisis in the U.S.* at xxv (January 2011) ("[T]he existence of millions of derivatives contracts of all types between systemically important financial institutions – unseen and unknown in this unregulated market – added to uncertainty and escalated panic[.]").[10] Indeed, the breadth and intensity of the crisis has been attributed in significant part to the CFMA itself and to the "hands-off" approach it

[10] Plaintiffs' observation that the CFTC has not attributed the financial crisis specifically to RICs thus misses the point. (Mem. 30.) There is a bigger picture here, which is that trading in commodity derivatives markets by any entity, by itself or in combination with other entities, presents risks that can be avoided, mitigated or more effectively countered by enhanced oversight.

embodied. *See* S. Rep. No. 111-176 at 29 ("By the time of the 2008 crisis, the derivatives market had grown to be almost fifty times as large . . . . Much of this growth has been attributed to the Commodities Futures Modernization Act of 2000"); 157 Cong. Rec. H686, H697 (Feb. 11, 2011) (Statement of Rep. Peterson) ("At the time that we did the CFMA back in 2000, we were told that the folks who were in the swap market were rich people . . . that they were gambling with their own money. Really, it was none of our business[.]").

Congress in Dodd-Frank reversed course, disavowing that philosophy in favor of a strong system of federal swap regulation and assigning the CFTC as the primary regulator of most swap transactions, Dodd-Frank § 722, 124 Stat. at 1672-75, and the CFTC chairman as a voting member of the FSOC, *id*. §§ 111(b)(1)(G) & 112(a)(1), 124 Stat. at 1393, 1395. Critically, Congress also amended the definition of "commodity pool operator" to include collective investment entities that transact in swaps or even a single swap. *Id*. § 721(a)(6), 124 Stat. at 1659-60; Final Rule, 77 Fed. Reg. at 11,258. The Commission has the discretion to exclude entities from that definition, but such action must be justified by a determination that an exclusion "will effectuate the purposes of the [CEA]." 7 U.S.C. § 1a(11)(B). In Dodd-Frank, Congress both expanded the "purposes of the [CEA]" to include systemic risk prevention in the swap markets, *see* Title VII, Part II, Dodd-Frank Act, 124 Stat. 1376, 1658-1751; 7 U.S.C. § 5(b), and fundamentally changed the definition of "CPO" from which Plaintiffs here wish RICs to be excluded. Dodd-Frank § 721(a)(6), 124 Stat. at 1659. The premises underlying the 2003 amendment were vitiated. Plaintiff Chamber admitted as much during the comment process:

> In July 2011 [the effective date of the Dodd-Frank amendments], the definition of a CPO will be expanded to cover both futures and swaps (*i.e.*, both exchange-traded and over-the-counter ("OTC") derivatives[]). This expansion represents ***a major change to the regulation of derivatives that, in turn, necessitates a complete overhaul of the administrative rules that apply to the derivatives***

markets.

Hirschmann Ltr. at 5 (emphasis added).

Plaintiffs' contention that the CFTC ignored the reasoning behind the 2003 deregulation rules is not true – "[c]hanged circumstances warrant[ed] revisions to these rules." Final Rule, 77 Fed. Reg. at 11,275.[11] The cases Plaintiffs cite in fact support the Commission's actions. *See Fox Television Stations*, 556 U.S. at 514 (rejecting heightened requirements for regulatory change); *Dillmon v. NTSB*, 588 F.3d 1085, 1089 (D.C. Cir. 2009) ("[T]he APA does not impose a heightened standard of review upon an agency to justify its departure from precedent."); *Wheaton Van Lines, Inc. v. ICC*, 671 F.2d 520, 527 (D.C. Cir. 1982) ("An agency's view of what is in the public interest may change, either with or without a change in circumstances." (internal quotation marks omitted)). While promotion of liquidity through reduced oversight may have been the driving consideration behind the 2003 deregulation rules (*see, e.g.*, Mem. 1, 8, 12, 14, 32), by 2012, following a financial crisis caused in substantial part by opacity in the derivatives markets, and after Congress' mandate of enhanced CFTC oversight, the Commission justifiably reached different conclusions than in 2003. As detailed below, the Commission articulated reasoned bases for each amendment to the rules.

C. The Registration Amendments are Justified.

Far from mere "paperwork" (Mem. 38), CFTC "[r]egistration is the kingpin of the statutory machinery, giving the Commission the information about participants in commodity trading which it so vitally requires to carry out its other statutory functions of monitoring and

[11] Plaintiffs also complain that the "Commission provided no explanation why it was departing from a nearly 30-year history of uniform treatment for 'otherwise regulated' entities." (Mem. 33). That is not true – as explained in the Final Rule release, the Commission has been provided with no data to suggest similar levels of derivatives activity by other classes of excluded entities. 77 Fed. Reg. at 11,255-56.

enforcing the [CEA]." *CFTC v. British Am. Commodity Options Corp.*, 560 F.2d 135, 139-40 (2d Cir. 1977); *see also CFTC v. Savage*, 611 F.2d 270, 280 (9th Cir. 1979) (CTA registration serves an important public purpose under the CEA). While Plaintiffs tend to blur the various requirements for operating as a CPO, the Final Rule discusses registration separately from financial reporting and from other compliance obligations. This is because, in the Commission's view, registration itself has independent value.

First, through registration, the Commission obtains information on the identity, organizational form, location of business offices and records, and principal officers of registered CPOs. *See* 7 U.S.C. § 6n(1)(A)-(F). This information allows the CFTC to track market developments, to make inquiries, and to intervene quickly when there is evidence of CEA or regulatory violations or of potential economic risks that may affect markets, traders, individual CPOs, or other institutions connected to CPOs. Once an entity is registered as a CPO, the CFTC may invoke its authority under 7 U.S.C. § 6n(3)(A) to require the registrant to "maintain books and records and file such reports . . . as may be prescribed by the Commission." Books and records must be "open to inspection by any representative of the Commission or the Department of Justice." *Id.* Registration thus provides a legal predicate both for the systematic reporting challenged in this case, *see infra* Part I(D), and for obtaining access to information in response to market developments or evidence of CEA violations. As Plaintiff ICI acknowledged at the Roundtable, "books and records and that kind of transparency is very valuable for a regulator to make sure that things are operating in the way the funds are representing." Roundtable Tr. 168.

Second, registration ensures that entities meet minimal requirements of integrity. When the CFTC's enforcement and market oversight divisions wish to locate and identify an entity within the markets they monitor, registration provides basic identity information (location and

affiliates) to facilitate immediate on-site access. 7 U.S.C. § 6n(1); 17 C.F.R. § 3.10(a). Failure to register as a CPO under 7 U.S.C. § 6m(1) may itself be grounds to shut down a CPO before definitive proof of fraud is available. The CEA also establishes certain disqualifications from registration. 7 U.S.C. § 12(a)(2)-(3).

Third, registration brings a CPO within the purview of NFA, to which the CFTC has delegated registration and related functions. *See, e.g.*, 17 C.F.R. § 3.2. The CFTC and NFA have an efficient, decades-old relationship that does not exist between the Commission and other SROs, such as FINRA, the primary securities-industry SRO. The CFTC and NFA share data on registered entities. NFA performs background checks on derivatives professionals, maintains a website to alert the public to registration and disciplinary information, and administers checks on competency, including the National Commodity Futures Exam ("Series 3"), which tests applicants' knowledge of the derivatives markets, rules, and regulations. These are subjects not covered in examinations for securities professionals.

While Plaintiffs argue that registration by RICs with the CFTC is unnecessary because their members are already regulated by the SEC, the Commission considered and gave a reasoned basis for rejecting that argument. The CFTC explained that it sought to regulate CPOs in their capacity as CPOs operating in derivatives markets and with respect to CFTC-regulated products – not as RICs operating in SEC-regulated markets with respect to securities products. Final Rule, 77 Fed. Reg. at 11,278. Plaintiffs make much of the Commission's true statement that it shares with the SEC "many of the same regulatory objectives" (Mem. 15 (citing Final Rule, 77 Fed. Reg. at 11,278)), but they take the statement out of its context, in which the CFTC was emphasizing the uniqueness of its own mission, distinct from the SEC:

> *While* the Commission and the SEC share many of the same regulatory objectives, including protecting market users and the

> public from fraud and manipulation, the Commission administers the CEA to foster open, competitive, and financially sound *commodity and derivatives markets*.

Final Rule, 77 Fed. Reg. at 11,278 (emphases added); *see also* Letter of Sen. D. Feinstein (Nov. 30, 2011) (observing that the SEC "does not have the equivalent expertise or experience in overseeing commodity related sales and trading practices").

Plaintiffs' argument incorrectly presumes that registration is simply a means to obtain financial data.[12] Although the CFTC's ability to obtain that data from entities in the commodity futures and derivatives markets is important, the CFTC articulated value in registration independent from financial reporting. For example:

> [R]egistration 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. The Commission has clear authority to take punitive and/or remedial action against registered entities for violations of the CEA or of the Commission's regulations.

Id. at 11,254; *see also id.* at 11,277 ("benefits of registration," including minimum standards of fitness and competency). The Commission stated from the outset of this rulemaking that, in light of recent economic events and Congress' Dodd-Frank response, it was no longer of the view that SEC regulation was sufficient, and that it was necessary to exert greater oversight of entities participating more than a de minimis amount in the CFTC's jurisdictional markets. *Id.* at 11,253; NPRM, 76 Fed. Reg. at 7977.

The Commission also emphasized the risk of regulatory evasion if the CFTC were to permit entities to avoid regulation as CPOs simply because they were registered in another

[12] Even if registration were merely a gateway to financial data, which it is not, the Rule would not be duplicative of SEC regulation. As explained below, the CFTC seeks financial data that is distinctly oriented to its regulatory purposes. *See* Part I(D), *infra.*

capacity with the SEC. There is no redundancy with SEC regulation when some RICs in question are RICs "in name only," entities who would otherwise be regulated only by the CFTC. This is exemplified by the reports from NFA and Senators Coburn and Levin about offshore corporations being used to funnel derivatives investments to U.S. consumers:

> The Commission received many comments regarding the use of Controlled Foreign Corporations [(CFCs)] by registered investment companies for the purpose of engaging in commodities trading. * * *
>
> * * *
>
> The Commission . . . believes that CFCs that fall within the statutory definition of "commodity pool" should be subject to regulation as a commodity pool.

Final Rule, 77 Fed. Reg. at 11,260. Plaintiff ICI argued during the comment process that these offshore CFCs did not seek registration as RICs for any untoward evasive purpose, ICI Comment Letter at 4, 24 (April 12, 2011), but other commenters argued that this practice of using in-name-only RICs to skirt CFTC regulation violated basic fairness:

> We enthusiastically support the Commission's proposal to narrow the . . . "blanket" exemption from commodity pool/CPO status for [RICs] . . . . Such corrective action, in our view (as well as that of numerous industry participants), became appropriate when the SEC changed, in 2008–2009, its longstanding position that an entity which was not definitionally an "investment company" . . . could not voluntarily register with the SEC as such. Once that precedent was reversed, there were several highly publicized instances of outright commodity pools being organized as RICs but exempted from the Commission's jurisdiction under Rule 4.5.

D. Sawyier (Sidley Austin LLP) Ltr. at 8-9.

Plaintiffs also deride the Final Rule as "wholly irrational" because, in their words, it seeks to "ensure uniform treatment of regulated entities," but without requiring pensions, trusts, and banks to register, while subjecting RIC/CPOs to dual regulation inapplicable to other CPOs. (Mem. 31.) However, Plaintiffs misquote the Commission, which, in the cited passage, was

discussing the problem of in-name-only RICs functioning as de facto CPOs. Final Rule, 77 Fed. Reg. at 11,255. The Commission stated that these "entities offering services substantially identical to those of a registered CPO should be subject to substantially identical regulatory obligations." *Id.* This passage is clear on its face that the Commission was referencing uniform treatment of entities engaged in *the same business activities*. *Id*. Different regulation follows naturally from *different* business activities. The Commission explained that it "is unaware of other classes of entities that are excluded from the definition of CPO engaging in significant derivatives trading." Final Rule, 77 Fed. Reg. at 11,255. But, the Commission stated, if it should become aware of such activities, it would consider appropriate action. *Id.* at 11,255-56. That explanation was reasonable.

In the aftermath of the financial crisis, and with Congress' directive to the CFTC to regulate the swaps market and guard against systemic risks, the Commission's decision to reassert its longstanding statutory authority to regulate RICs operating in the commodity derivatives markets was eminently reasonable. As explained below, because the various criteria the Commission chose for the revised, narrower exclusion under Rule 4.5 were also reasonable, none of Plaintiffs' challenges to those criteria have merit.

1. The CFTC's Selection of a 5-Percent Trading Threshold Was Reasonable.

When an agency sets a rule "in which percentage terms play a central role," it has broad discretion to "make a rational legislative-type judgment" in selecting the percentage. *Vonage Holdings Corp. v. FCC*, 489 F.3d 1232, 1242 (D.C. Cir. 2007). The agency "may not pluck a number out of thin air," but courts recognize that "a line has to be drawn" somewhere, and so the chosen threshold will be upheld unless "patently unreasonable" or "a dictate of unbridled whim." *Id*.; *see also Chamber of Commerce v. SEC*, 412 F.3d 133, 142 (D.C. Cir. 2005) (recognizing

that an "agency need not—indeed cannot—base its every action upon empirical data"). Plaintiffs do not come close to meeting this standard in challenging the 5-percent threshold for triggering registration, which was in place from 1985 to 2003. The decision to restore that threshold to its former level was rational.

As noted above, the 5-percent threshold was originally established by the CFTC in 1985 in close consultation with Congress, and was based on the Commission's experience with case-by-case requests for exclusion. 1985 Rule, 50 Fed. Reg. at 15,875. The idea was that a CPO that was "overhedging," by hedging more than 100% of its assets, required oversight by the Commission. *Id*. at 15878. In the 1985 Rule, referenced in this proceeding, *see* NPRM, 76 Fed. Reg. at 7983, the Commission illustrated, using an example based on a pool invested in commodity derivatives, that even at 5 percent, leverage and volatility could lead to substantial exposure in multiples of the pool's total assets. 1985 Rule, 50 Fed. Reg. at 15878 & n.64. In the Final Rule, the Commission also cited the 2003 rulemaking in which a 5-percent threshold was adopted to create an exemption for de minimis trading by commodity pools that are not RICs, *see* Final Rule, 77 Fed. Reg. at 11,255, and noted that "[f]ive percent remains the average required for futures margins," and, with respect to higher-margin products, the alternative net notional test "provides flexibility," *id*. at 11,256.

Some commenters, including Plaintiffs, argued that the 5-percent threshold was too strict and argued that their trading at a much higher level would not pose real risk. But the Commission observed that "no data was provided to support this assertion." *Id*.[13] In that

[13] Amicus Mutual Fund Directors Forum ("MFDF") complains that for entities trading in uncleared swaps, the 5-percent margin threshold will be of little assistance, given allegedly higher margins in these markets. (Brief for the Mutual Fund Directors Forum as Amicus Curiae in Support of Plaintiffs' Motion for Summary Judgment ("MFDF Br.") at 18 n.8.) That
---footnote continued on next page---

context, the CFTC was both prudent and within its discretion to choose a threshold with which it had substantial experience. *Vonage Holdings Corp.*, 489 F.3d at 1242.

2. Plaintiffs Virtually Ignore the Alternative, 100-Percent Test.

Plaintiffs' criticism of the 5-percent test is further flawed because it essentially ignores the fact that this test is only one alternative in a two-prong test for whether a RIC must register as a CPO. In response to arguments by some commenters that the 5-percent de minimis test could be exceeded under circumstances where the entity nevertheless lacks substantial exposure to highly leveraged instruments, the CFTC created the 100-percent net notional value test under Rule 4.5(c)(2)(iii)(B).[14]

Under the 100 percent net notional value test, an entity may avoid inclusion as a CPO by demonstrating that, although it has posted margins for derivative investments amounting to more than 5 percent of the portfolio's liquidation value, total notional value of the contract suggests less leverage than these initial margins might imply. Final Rule, 77 Fed. Reg. at 11,257 (the alternative test "provide[s] otherwise regulated entities that use certain classes of [derivatives] with higher initial margin requirements with an opportunity to also receive exclusionary relief from the definition of CPO"). In performing that calculation, RICs are also permitted to offset certain similar derivatives by netting futures contracts across different markets and netting swaps cleared by same derivatives clearing organization. *Id*. This is a "significant change" from the

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complaint illustrates the soundness of the Rule. In the Commission's judgment, if entities trading in uncleared or less transparent markets must register, that result is consistent with its regulatory goals and Dodd-Frank's purpose to establish greater transparency in these dark markets. Final Rule, 77 Fed. Reg. at 11,252, 11,262, 11,265, 11,277.

[14] The original Federal Register publication erroneously omits an "or" before subsection B of Rule 4.5(c)(2)(iii). This is corrected in the technical corrections, to make plain that this 100-percent test is an alternative to the 5-percent trading limitation. *See* 77 Fed. Reg. 17,328 (effecting this correction to a Federal Register error by adding "or" before subsection B).

proposal to the Final Rule. *Id*. at 11,254. Plaintiffs' and MFDF's arguments that the 5-percent test is too strict – and that many of their members may in fact not be using derivatives in a way that would threaten the value of the entire pool – largely ignore this alternative basis for exclusion.[15]

3. It Was Reasonable to Include Swaps within the 5-Percent and 100-Percent Trading Threshold Measures.

Like some commenters in the rulemaking, Plaintiffs here suggest that the Commission should simply have "exclude[d] swaps from the [threshold] determination." (Mem. 41.) The suggestion itself is entirely divorced from the historical and legislative context in which the Commission was acting. The Commission explained that a key purpose of the Final Rule is to help implement Dodd-Frank's policy of greater transparency in the heretofore largely unregulated swaps markets. While ignored by Plaintiffs, this reason is repeated throughout the rule. *See, e.g.*, Final Rule, 77 Fed. Reg. at 11,252, 11,256, 11,258, 11,263. The CFTC's decision not to scuttle its own regulatory objectives and ignore Dodd-Frank's purposes by turning a blind eye to an entity's activity in the swaps market was reasonable and far from arbitrary and capricious.

Plaintiffs' Memorandum largely ignores the obvious reason for including swaps in the threshold, instead focusing on and misconstruing a technical aside in the Rule preamble in response to "a comment asking for additional clarification." The CFTC noted that to eliminate

[15] The Commission originally proposed this alternative test in 2002 as a test for exclusion from registration of RICs. Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Pool Operator," 67 Fed. Reg. 65,743, 65,744 (Oct. 28, 2002 NPRM). This proposal was superseded in 2003 when the Commission decided to exclude RICs from the definition of CPO with no trading threshold at all. 2003 Rule, 68 Fed. Reg. at 47,223-24. However, at the same time, the CFTC adopted the 100-percent net notional value test as part of the standard for exempting certain non-RIC CPOs from registration requirements. *Id*. at 47,225. The test has been used for this purpose since that time. *See* 17 C.F.R. § 4.13(a)(3).

swaps from the Commission's regulatory allowance of a small amount of speculative derivatives trading would, by operation of the CEA, require registration and not grant the regulatory relief commenters were seeking. Final Rule, 77 Fed. Reg. at 11,258. Rather than "nonsensical" (Mem. 41), the point is a limited, technical reminder, perhaps inelegantly phrased, that the CFTC's threshold test carves out entities that otherwise fall within the statutory definition of a CPO. Plaintiffs are no doubt correct that, as a matter of English grammar, one "could . . . fashion language to exclude swaps from the determination" (Mem. 41), but only a regulator bent on undermining its own clearly articulated policies would do so. *See* Final Rule, 77 Fed. Reg. at 11,252; NPRM, 76 Fed. Reg. at 7978 (objective of rule is "to (1) bring the Commission's CPO and CTA regulatory structure into alignment with the stated purposes of the Dodd-Frank Act").

4. The Bona Fide Hedging Requirement Is Well-Supported by the Record.

Plaintiffs also argue in favor of "a broader definition of bona fide hedging." (Mem. 42.) Yet the Final Rule is far more generous in this regard even than the 1985 Rule, because it permits a RIC calculating adherence to the 5-percent threshold or the alternative test to *exclude altogether* commodity investments for bona fide hedging, which was not the case prior to 2003. Under the Final Rule, "bona fide hedging" includes only derivatives held to hedge against a position or transaction in an actual, underlying commodity. *See* 77 Fed. Reg. at 11,256. This can include financial commodities such as bonds, but does not include a general "risk management" hedge, *id*., as Plaintiffs would prefer (Mem. 42). The Commission determined it was necessary to draw a bright line because, unlike the 1985 Rule, bona fide hedging is now an exclusion that, if open to subjectivity, could be abused and thus defeat the purpose of the 5-percent threshold. Final Rule, 77 Fed. Reg. at 11,256.

Plaintiffs would prefer a broader exclusion, but the CFTC articulated sound reasons for

rejecting the proposed alternatives. The Commission explained that, in its experience, an "important distinction" is that physical market offset hedging transactions "are unlikely to present the same level of market risk" because the investor holds an offsetting position in the cash market. *Id*. According to Plaintiffs, the Commission's observation from experience is "irrational" because "other risk mitigation strategies are *also* offset by exposure in another market" and such a "position is, by definition, a position that 'offsets' exposure." (Mem. 42-43, internal quotation marks omitted). The CFTC disagreed with that proposition in large part because, as reflected in the disparate comments on the subject, there is no industry consensus on how a "risk management" exception should be defined, and such a test would create a registration scheme without "objective criteria" to enforce it. *See* 77 Fed. Reg. at 11,256. Recent events have illustrated that, whatever a financier's intent may be in such a "risk mitigation strategy," derivatives do not always "offset" as anticipated. *See* Jamie Dimon, CEO, J.P. Morgan Chase & Co. (May 10, 2012) ("This portfolio has proven to be riskier, more volatile and less effective as an economic hedge than the firm previously believed.").[16] Given that this rulemaking began in part due to concerns about offshore CPOs re-characterizing themselves as "RICs" simply to avoid regulation, the subjective nature of Plaintiffs' proposal is not an idle concern, and the Commission's reasonable and prudent decision should not be disturbed. *Id*.

5. The Marketing Restriction Was Proposed and Finalized in Accordance with the APA.

Rule 4.5 also restricts excluded entities from marketing themselves "to the public as or in a commodity pool or otherwise as or in a vehicle for trading in commodity futures, commodity

[16] *Quoted in* "J.P. Morgan's $2 Billion Blunder," *Wall Street Journal* (May 11, 2012). While the J.P. Morgan event post-dates the administrative process, it further illustrates that the Commission's judgment was reasonable.

options, or swaps markets." Final Rule, 77 Fed. Reg. at 11,283. Several commenters, including Plaintiff ICI, requested guidance in the form of a list of factors that the CFTC would apply in enforcing this restriction. *Id*. at 11,258, 11,259 & n.76. In the preamble to the Final Rule, the CFTC listed seven such factors derived from the comments themselves, specifying what considerations the Commission "believes . . . are indicative of marketing a registered investment company as a vehicle for investing in" commodities in violation of Rule 4.5. *Id*. at 11,258-59 & n.77.

Their request accommodated, Plaintiffs now contend that the CFTC should have published the factors for notice and comment. Notice and comment was not required, however, because the seven factors are not a new rule, but a statement of policy reflecting how the Commission intends to determine compliance with Rule 4.5's marketing restriction. *Id*. at 11,258-59; *see* 5 U.S.C. § 553(b)(3)(A). The "fundamental characteristic" of a rule requiring notice and comment is that it "has binding effects on private parties or on the agency." *GMC v. EPA*, 363 F.3d 442, 448 (D.C. Cir. 2004) (internal quotation marks omitted). A statement of policy, in contrast, communicates the agency's "position with respect to how it will . . . typically enforce . . . the governing legal norm." *Syncor Int'l Corp. v. Shalala*, 127 F.3d 90, 93-95 (D.C. Cir. 1997). In this case, the governing legal norm is Rule 4.5. While Plaintiffs refer to the seven factors as a "test" (Mem. 45), the Commission rejected that characterization, stating that the factors "should be instructive," and that the Commission "will determine whether a violation of the marketing restriction" in Rule 4.5 "exists on a case by case basis through an examination of the relevant facts." Final Rule, 77 Fed. Reg. at 11,259. The CFTC's identification of the factors thus reflects a statement of policy that is not subject to notice and comment requirements.

Even if notice and comment did apply, the NPRM provided ample notice on this subject.

To satisfy the APA's notice requirement, an agency's final rule need only be a "logical outgrowth" of its proposal. *CSX Transp., Inc. v. Surface Transp. Bd.*, 584 F.3d 1076, 1079 (D.C. Cir. 2009) (internal quotation marks omitted). This test is satisfied where "the NPRM expressly asked for comments on a particular issue." *Id*. at 1081. Here, the NPRM asked for comments on how the marketing restriction might be narrowed. 76 Fed. Reg. at 7984. Plaintiff ICI, in its own extensive comments on the NPRM, specifically *requested* that the CFTC provide a list of "relevant factors" it would consider in enforcing the provision, but it chose not to propose any factors of its own. ICI Letter at 4, 24-27. Other commenters did suggest factors, underscoring that Plaintiffs had the opportunity to do so. 77 Fed. Reg. at 11259 n.77. Plaintiffs also cannot and do not attempt to show any prejudice, another requirement in a claim of deficient notice. *Am. Coke & Coal Chems. Inst. v. EPA*, 452 F.3d 930, 939 (D.C. Cir. 2006).

D. The Reporting Requirements are Justified.

The Final Rule finalizes only one substantive compliance requirement for registered CPOs – financial reporting via Form CPO-PQR pursuant to Rule 4.27. The Final Rule modifies both the content and the frequency of reporting by CPOs to the Commission.

Plaintiffs do not dispute that the Commission has the authority to require reporting through Form CPO-PQR, as the CEA plainly gives the CFTC discretion to prescribe such reports. 7 U.S.C. § 6n(3)(A). Rather, Plaintiffs broadly challenge the need for such reporting. Although Plaintiffs assert that Form CPO-PQR is "wholly unnecessary" because RICs already disclose information to the SEC (Mem. 39-40), none of the systemic risk data required in Form CPO-PQR is currently being reported by RICs to regulators. While the Commission gave detailed explanations for requesting this data, NPRM, 76 Fed. Reg. at 7980-82, Plaintiffs have not asserted a single error in the CFTC's reasoning or otherwise pointed to any specific information that they contend is superfluous or available from another source. In light of the

CFTC's long history and regulatory expertise in the area of commodity derivatives, the Commission's judgment concerning the frequency and variety of the technical data it needs is entitled to the highest deference.[17] *See Kennecott Greens Creek Min. Co. v. Mine Safety and Health Admin.*, 476 F.3d 946, 954-55 (D.C. Cir. 2007) ("extreme degree of deference" to agency evaluating scientific data within its area of expertise).

Consistent with Dodd-Frank's focus on systemic threats to financial stability, Rule 4.27 scales the amount of information required in Form CPO-PQR by entity size, with the most information required from the largest pools. Rule 4.27 establishes three Schedules – A, B, & C – with Schedule B required of CPOs with $150 million or more in assets under management and Schedule C required of CPOs with $1.5 billion or more. Schedule A requires primarily basic demographic information and monthly rates of return, while Schedules B and C require information concerning assets devoted to different trading strategies, the use of algorithmic and high frequency trading, counterparty credit exposure, aggregate derivative positions, portfolio liquidity, investor liquidity, risk metrics, and duration of fixed-income assets. This tiered approach balances the potential burdens of risk reporting with the CFTC's need for more information regarding the entities it regulates. *See also infra* Part III (discussing cost-benefit considerations). Contrary to Plaintiffs' protests that the Final Rule is redundant, with the

[17] Amicus MFDF states that the CFTC's "primary motivation" here is to ensure its "own separate stream of information about the management of registered investment companies" to provide to FSOC. (MFDF Br. 6.) Although the CFTC takes seriously its important responsibility with respect to assisting FSOC, MFDF's reductionist view of the purpose for the data collection is not correct. The NPRM and Final Rule state that the CFTC seeks this information for the agency's own regulatory purposes, as expanded by Dodd-Frank. 77 Fed. Reg. at 11,252 (first three paragraphs of "background on proposal" concern the CFTC's regulatory mission, including Dodd-Frank's grant of swaps jurisdiction and general statutory purpose, including "improving accountability and transparency in the financial system, [and] to end 'too big to fail'"); NPRM, 76 Fed. Reg. at 7978 (listing FSOC as the last of four factors motivating the proposed Rule).

exception of the basic information on pool structure and monthly rates of return requested in Schedule A, *none* of the information required in Form CPO-PQR is now being reported regularly by RICs to financial regulators or to the public.

Previously, registered commodity pools made periodic reports to NFA through a form called "Form PQR." As explained in the NPRM, the CFTC determined in 2011 that this was insufficient "for the Commission to effectively monitor the risks posed by those participants to the commodity futures and derivatives markets." NPRM, 76 Fed. Reg. at 7978. Accordingly, the CFTC proposed to revise the periodic reports filed by CPOs, establishing Form CPO-PQR to ensure that the agency can "adequately oversee the commodities and derivatives market and assess market risk associated with pooled investment vehicles under its jurisdiction." *Id*. at 7977.

As the NPRM further explained, Form CPO-PQR is based on the CFTC's experience regulating commodity pools, "consultation with staff of the FSOC, the SEC, and NFA as well as the purpose and requirements of the Dodd-Frank Act." *Id*. at 7980 (footnote omitted). On the same day the NPRM was published in this rulemaking, the CFTC and SEC jointly published a notice of proposed rulemaking on Form PF, concerning private funds (commonly known as hedge funds). Reporting by Investment Advisers to Private Funds & Certain CPOs & CTAs on Form PF, 76 Fed. Reg. 8068 (proposed Feb. 11, 2011). After comments were received on both proposed rules, and after numerous consultations between the SEC and the CFTC, the two commissions jointly issued a final rule adopting Form PF. Reporting by Investment Advisors to Private Funds & Certain CPOs & CTAs on Form PF, 76 Fed. Reg. 71,128 (Nov. 16, 2011)

("Final PF Rule").[18] Shortly thereafter, the CFTC issued this Final Rule, adopting Form CPO-PQR. 77 Fed. Reg. 11,252.

Form CPO-PQR solicits information "that is generally identical to that sought through Form PF." Final PF Rule, 76 Fed. Reg. at 71,128. Like Form PF, Form CPO-PQR was created "in consultation with other financial regulators tasked with overseeing the financial integrity of the economy." NPRM, 76 Fed. Reg. at 7978. SEC staff participated in the development of Form CPO-PQR, in harmonization of the two recordkeeping and disclosure regimes, and were present at the CFTC Roundtable on this rule. *See*, *e.g.*, Roundtable Tr. 3, 6, 12, 227-28. Almost every question on Form CPO-PQR is either taken from Form PQR, or is taken directly or modified from a question on Form PF. Thus, far from "singling out" RICs (Mem. 31), the rules establish reporting obligations for all CPOs, including dual-registered advisors to private funds.[19]

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[18] An investment adviser must file Form PF if it: (1) is registered or required to register with the SEC; (2) advises one or more private funds; and (3) has at least $150 million in regulatory assets under management attributable to private funds. 76 Fed. Reg. at 71,132. A CPO or CTA that is also registered or required to register with the SEC as an investment adviser and satisfies the above conditions *must* file Form PF for any commodity pool it manages that is a "private fund," and *may* file Form PF for any commodity pool it manages that is not a "private fund." *Id*. Form PF is appended to the joint rule release, and is also available at http://www.sec.gov/about/forms/formn-sar.pdf

[19] Because advisers to private funds will file information on their derivatives use to the SEC though Form PF, private funds are permitted to satisfy many of the filing requirements of CPO-PQR through additional Form PF filings. Plaintiffs misconstrue the statement of CFTC Chairman Gensler to the effect that duplicate filings will not be required from those who register with both the SEC and the CFTC. (Mem. 14, 31 n.14.) The Chairman's comments came in the context of a discussion concerning those required to file Form PF. In fact, entities filing form PF with the SEC will not have to file each schedule of Form CPO-PQR. Such dual registrants would only be required to file demographic information with the CFTC through Schedule A, and may even file Form PF for the pools it operates that are not private funds. See Final Rule, 77 Fed. Reg. at 11,266-67. Through the limited information in Schedule A, the CFTC would be informed of the entity's existence and key service providers, and would acquire the rest of the information from the SEC. No such system would be possible as to mutual funds and other RICs, because they are not required to file Form PF, and the SEC therefore does not have equivalent information on their use of derivatives.

Among other things, Rule 4.27 is designed to align the regulation of CPOs with the purposes of the Dodd-Frank Act; improve accountability and increase transparency of the activities of CPOs and their pools; and facilitate collection of data to assist FSOC. NPRM, 76 Fed. Reg. at 7978. The proposed amendments would also "have the added benefit of enabling the Commission to more efficiently deploy its regulatory resources and to more expeditiously take necessary action to ensure the stability of the commodities and derivatives markets." *Id*.

Plaintiffs' argument that the CFTC "identified no problems" that justified action is wrong. (Mem. 1, 20.) Without Form CPO-PQR, the information received by the CFTC is "limited, not designed to measure systemic or market risk in any meaningful way, and is only submitted by registered CPOs on an annual basis. In addition, the annual financial reports filed by CPOs do not disclose information regarding CPOs' use of stress testing or the tenor of fixed income assets held by commodity pools." NPRM, 76 Fed. Reg. at 7978. The Commission accurately explained that, without Form CPO-PQR, there "currently is no source of reliable information regarding the general use of derivatives by registered investment companies." Final Rule, 77 Fed. Reg. at 11,275. Accordingly, Form CPO-PQR was designed specifically to "increase the amount and quality of information regarding a previously opaque area of investment activity." *Id*. at 11,281.[20] Plaintiffs' repeated assertions that "reliable information" can be obtained through "publicly available disclosures already made by investment companies

[20] As stated in the joint SEC and CFTC rule concerning Form PF, recent reports from international economic groups such as the Financial Stability Board and the International Monetary Fund emphasize the importance of identifying and addressing gaps in information available to systemic risk regulators. Final PF Rule, 76 Fed. Reg. at 71,130. Moreover, "regular and timely" reporting of asset positions and leverage levels will increase transparency and help regulators measure and manage possible systemic risk. Stephen Brown, *et al*., Hedge *et al*., *Hedge Funds, Mutual Funds, and ETFs*, in REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 360 (Viral V. Acharya, et al., eds., 2011) (quoted in 76 Fed. Reg. at 71,165).

to the SEC" (Mem. 12, 30; *see also* MFDF Br. 9, 16) are wrong, because such disclosures do not comprehensively address these companies' activities in *commodity derivatives* markets.

While Plaintiffs cite Plaintiff ICI's own comment letter for the proposition that the information RICs provide to the SEC is "generally comparable" (Mem. 40), in the letter itself Plaintiff ICI admitted otherwise. After describing data it provides to the SEC, Plaintiff ICI noted that Schedule A includes requests for information already contained in SEC filings, but these included only minimally burdensome items such as the entity's name, address, assets under management, key service providers, and monthly rates of return. ICI Comment Letter, App. A, p. vii-viii, column 2. Plaintiff ICI conceded in the same letter that there are "differences between the requirements of Form N-SAR [the SEC's main filing for RICs] and proposed Form CPO-PQR" and acknowledged that "these differences generally reflect the fact that Form CPO-PQR is intended to obtain information relating to systemic risk." *Id*. at p. vii-viii, column 3. ICI failed to identify a single overlapping question in Schedule B, because there are none. *Id*. at p. viii. Finally, regarding Schedule C, ICI again failed to identify any material overlap, conceding that SEC Form N-SAR "does not require an investment company to report investment and exposure on an aggregate basis or certain more detailed information required by Schedule C of Form CPO-PQR." *Id.* at p. ix, column 1.[21]

[21] There is a good reason the SEC does not require investment companies to report this information: trading levels and the use of risk metrics implicate competitively sensitive and proprietary information. Such information is not suitable for the disclosure regime of the SEC, which aims to make information accessible to the public. RICs file Form N-SAR with the SEC semi-annually. http://www.sec.gov/about/forms/formn-sar.pdf. Information disclosed on Form N-SAR is made public and available to anyone. However, Form CPO-PQR requires "sensitive information that implicates other proprietary secrets, which, if revealed to the general public, could put the CPO at a competitive disadvantage." Final Rule, 77 Fed. Reg. at 11,271. Accordingly, aside from certain basic information in Schedule A, all of the information required by Form CPO-PQR will be non-public. *Id*. This also reflects the CFTC's "general policy to

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The issue of overlapping financial reports arose again at the Roundtable, when CFTC staff asked about Form CPO-PQR "line item by line item what you don't like or what you think is inconsistent with the SEC's [regime]." Roundtable Tr. 229. No one gave a direct answer, and not a single commenter at the roundtable suggested that the information required in Schedules B and C – the overwhelming majority of information requested – is available on a regular basis from the SEC or any other accessible source.

Underscoring the flaw in Plaintiffs' suggestion that the CFTC simply ask the SEC for this data, the SEC's 2011 concept release on derivative investments by RICs, cited in the Final Rule, states that "complete data concerning the nature of derivatives activities of funds is unavailable," and refers the reader to Plaintiff ICI's own submission *in this CFTC rulemaking* as a "partial snapshot of derivative activity by selected fund complexes." *See* SEC Release, 76 Fed. Reg. at 55,238 n.7 (cited at 77 Fed. Reg. at 11,255 & n.36). Amicus MFDF also makes the unreasonable suggestion that the CFTC simply convince the SEC to acquire this information on the CFTC's behalf. (MFDF Br. 17.) But because the SEC does not regulate the markets for most swaps and financial derivatives, the SEC has no ostensible need for such information. It would make little sense to expect the SEC to expend its own resources in monitoring risks posed to the derivatives markets by commodity pool operators.[22]

Plaintiffs and MFDF next contend that the CFTC's "large-trade reporting" or "swap-data-reporting" systems should provide the CFTC with sufficient information (Mem. 6; MFDF Br.

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protect from public disclosure those portions of 'nonpublic records' filed with it, which are exempted under the commercial and financial information exemption from FOIA." NPRM, 76 Fed. Reg. at 7982 (citing 17 C.F.R. § 145.5) (footnote omitted). This difference underscores the different regulatory purposes of the SEC and CFTC.

[22] The Joint Final Rule release concerning Form PF stated, "[t]he SEC would not necessarily have required the same scope of reporting if the information reported on Form PF were intended solely for the SEC's use." 76 Fed. Reg. at 71,130.

17). But the CFTC, which possesses the relevant expertise with respect to the information it needs to carry out its core functions, reached the opposite conclusion, and that judgment is entitled to deference. While reporting entities are required to provide snapshot "large trader reports" if they exceed a given threshold within a single commodity market, *see* 17 C.F.R. §§ 17.00, 18.00, these cannot serve the purposes of Form CPO-PQR, which will include systematic reporting of information on all positions, liquidity, trading strategies and risk metrics of CPOs, none of which are required in the large trader report. Large trader reporting was intended to address manipulation of single markets, whereas Form CPO-PQR is intended to address the systemic risk posed by, for example, commodity pool failure and to provide information on "trends across funds that are not large enough to trigger the [large trader] reporting obligation, but that may nevertheless impact the market." Final Rule, 77 Fed. Reg. at 11,261. A snapshot report of a large position in one particular market does not provide information "regarding the relationship between a large position held by a pool and the rest of the pool's other derivatives positions and securities investments" as will Form CPO-PQR. *Id*. at 11,268. As the Commission concluded, Form CPO-PQR will provide the Commission with "substantially more detail regarding the activities of entities engaged in derivatives trading and will better enable it to assess the risk posed by a pool or CPO as a whole." *Id*.

The swap data reporting system is similarly ill-suited to the objectives of Form CPO-PQR. That system is not yet even in effect and will be required only prospectively, for future swap transactions following a three-year phase-in period. Swap Data Recordkeeping & Reporting, 77 Fed. Reg. 2136, 2138, 2150 (Jan. 13, 2012). Swap reporting, moreover, is designed to provide regulators with visibility regarding counterparties to individual swap transactions; Rule 4.27, by contrast, is designed as a protection for the markets from the systemic

risks posed by CPOs' commodity investment activity. Even when fully implemented, the swap data reporting system will not provide any information about the entity's positions across different types of instruments or different markets, or the entity's overall leverage or liquidity. *Id*. at 2138. Plaintiffs again have suggested no way in which these different, specialized reporting requirements can adequately substitute for regular and comprehensive reporting by all CPOs through Form CPO-PQR.

Finally, MFDF references the CFTC's "special call" authority (MFDF Br. 17), but, as the Commission explained in the Final Rule, that function cannot achieve the ends intended by regular and systematic reporting under Form CPO-PQR. The collection of data under the CFTC's special call authority is "generally reactive in nature," and occurs only "after it bec[omes] aware of an issue." Final Rule, 77 Fed. Reg. at 11,261. Regular reporting through Form CPO-PQR, by contrast, will "enable the Commission to be more proactive in assessing possible threats to market stability and in carrying out its duties in overseeing market participants generally." *Id*. Like the CFTC's other specialized tools, the special call provisions were not "intended to provide the kind of data requested of registered entities on forms CPO-PQR with the regularity proposed under § 4.27." *Id*.

In sum, the Commission's decision to promulgate Rule 4.27 was reasonable because systematic and comprehensive data concerning the use of derivatives by RICs is not readily available from any source. Form CPO-PQR will "increase the amount and quality of information available to the Commission regarding a previously opaque area of investment activity." *Id*. at 11,281. Rule 4.27 is critical because the CFTC "cannot protect against risks of which it is not aware. By creating a reporting regime that makes the operations of commodity pools more transparent to the Commission, the Commission is better able to identify and address

potential threats." *Id*. That RICs must also report to the SEC information about their activities in securities markets is no reason to preclude the CFTC from requiring RICs and other CPOs to report information on their investments in derivatives markets, concerning products over which the CFTC has exclusive or primary jurisdiction. The CFTC indisputably has the authority to require CPOs to file financial reports, and its decision to do so by implementing Form CPO-PQR was reasonable and should not be disturbed.

II. Plaintiffs' Claims Concerning Compliance Obligations that Are Part of an Ongoing Rulemaking, Not the Final Rule, Are Premature.

Plaintiffs also make several impermissible challenges to non-final agency actions that are not ripe for judicial review. As discussed above, regulations imposing compliance obligations on RIC/CPOs are subject to ongoing rulemaking pursuant to an NPRM issued February 24, 2012. Harmonization NPRM, 77 Fed. Reg. 11,345. Plaintiffs will not be subject to any such requirements until the conclusion of a reasonable period following the completion of that separate rulemaking process. Final Rule, 77 Fed. Reg. at 11,252 (60 days each between publication and effectiveness, and effectiveness and compliance). Many of Plaintiffs' arguments (and those of MFDF) relate to those issues alone. (*See, e.g.*, Mem. 34-35, 37-38; MFDF Br. 12-13.) The Court should dismiss those claims as unripe.

Courts apply a three-part test for ripeness, considering (1) whether delayed review would cause legal or practical hardship to plaintiffs; (2) whether judicial intervention would inappropriately interfere with further administrative action; and (3) whether courts would benefit from further factual development. *Ohio Forestry Ass'n, Inc. v. Sierra Club*, 523 U.S. 726, 732, (1998). Relatedly, only "final agency action" is reviewable under the APA. 5 U.S.C. § 704. Agency action is final only if (1) it marks the "consummation" of the agency's decisionmaking process; and (2) it is an action by which rights or obligations have been determined, or from

which legal consequences will flow. *Bennett v. Spear*, 520 U.S. 154, 177-78 (1997). When agency action involves several components, only those that immediately change rights and obligations are final for review, *Shoreham-Wading River Cent. Sch. Dist. v. U.S. NRC*, 931 F.2d 102, 105 (D.C. Cir. 1991), and where the potential for such effects depends on some future administrative action, those claims are unripe, *see, e.g.*, *CTIA-The Wireless Ass'n. v. FCC*, 530 F.3d 421, 424-25 (D.C. Cir. 2008). This is especially so where, as here, further consideration of the issues is "not theoretical, but real" and "review now may turn out to have been unnecessary." *Ohio Forestry Ass'n*, 523 U.S. at 735-36.

Plaintiffs and MFDF lodge a slew of protests concerning recordkeeping and disclosures to investors under the CFTC's Part 4 regulations (Mem. 12, 14-15, 16; MFDF Br. 12, 15), but they fail to mention that these requirements are contingent on future rulemaking action. Final Rule, 77 Fed. Reg. at 11,252, 11,259, 11,260, 11,272. The Commission intends to proceed expeditiously, but in the meantime, Plaintiffs are asking the Court to decide questions based on issues that may well be resolved through harmonization. And if those issues are not resolved because harmonization is never completed, Plaintiffs' claims would become moot because RICs that do not fall within the Rule 4.5 exclusion would only have to register and file Form CPO-PQR. *Id*.

Plaintiffs attack the very idea of this multi-step rulemaking process (Mem. 15-17, 37-38), but the APA "recognizes that agency rulemaking can occur in stages, and that review of initial steps should generally be deferred until the regulatory process is complete." *Am. Portland Cement Alliance v. EPA*, 101 F.3d 772, 776 (D.C. Cir. 1996). Indeed, Plaintiff ICI specifically requested further notice and comment on harmonization proposals. Roundtable Tr. 127-28.

In this context, it is misleading to assert, as Plaintiffs do, that the 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." (Mem. 11-12.) The Final Rule acknowledged the need for additional consideration of those issues and suspended the legal effect of recordkeeping and disclosure requirements for affected entities, while the Harmonization NPRM, issued the same day, contained extensive references to the relevant SEC forms, rules, and regulations. Final Rule, 77 Fed. Reg. at 11,346-48. Similarly, Plaintiffs' contention that the CFTC failed to respond to comments on these issues is wrong. (Mem. 12, 25.) In the Final Rule, the Commission cited each of the letters Plaintiffs reference as comments raising concerns about the "potential conflicts between the Commission's regulatory regime and that imposed by the SEC." 77 Fed. Reg. at 11,259 & n.79. Then, in light of the information received at the Roundtable and an additional three-week comment period that followed, *see* Roundtable Tr. 99, the Commission determined that yet more notice-and-comment rulemaking would be appropriate. 77 Fed. Reg. at 11,259.

As reflected in the Harmonization NPRM, the Commission is considering relief that would directly alleviate the hardships of which Plaintiffs complain. For 5 of the 11 areas of conflict between SEC and CFTC regulations, the CFTC has proposed allowing substitute compliance by adherence to SEC regulations.[23] For 4 others, the CFTC has proposed allowing the requested information to be disclosed instead in SEC filings.[24] With respect to the last two areas – the frequency of the provision to customers of account statements and the content of

[23] Under the proposal, RICs would be exempt from disclosure requirements under Rule 4.21, 4.22, and 4.23. Harmonization NPRM, 77 Fed. Reg. at 11,346. RICs would also be exempt from more frequent disclosures required by Rule 4.26, and the oath or affirmation required by Rule 4.22(h). *Id*. at 11,347-48.

[24] The proposal provides alternative methods of satisfying Rule 4.24(a), 4.25(d)(5), 4.25(d), and 4.24(i), which ordinarily require a cautionary statement, break-even points, and fees and expenses, and requires that they be located in the forepart of disclosures to investors.

disclosures regarding past performance of commodity pools less than three years old – the Commission has proposed maintaining its own standards but has also solicited comments on how it should harmonize those last two areas.[25] Although the Commission has yet to finalize this rulemaking, the proposal itself shows the lengths to which the Commission has gone to alleviate potential burdens arising from duplicative or inconsistent regulations.

In all events, the CFTC's interest in finalizing its policy and the court's interest in deciding the issues in a more concrete setting greatly outweigh any interest Plaintiffs may assert. *See AT&T Corp. v. FCC*, 369 F. 3d 554, 563 (D.C. Cir. 2004); *Utility Air Regulatory Grp. v. EPA*, 320 F.3d 272, 277-78 (D.C. Cir. 2003). Plaintiffs will suffer no hardship by awaiting the completion of the administrative process, because the relevant compliance dates are contingent on enactment of a final harmonization rule and provide additional time for CPO/RICs to comply. 77 Fed. Reg. at 11,252.[26] Nor is there any concern that the CFTC will delay unnecessarily, since the compliance date turns on the conclusion of the rulemaking. *See CTIA-The Wireless Ass'n*, 530 F.3d at 989 (observing that an "agency has no interest in putting off review in these circumstances"). Thus, Plaintiffs' challenges to compliance obligations other than Form CPO-PQR should be dismissed as unripe.

III. The CFTC Properly Considered Costs and Benefits.

CEA Section 15(a) requires the Commission to "consider the costs and benefits" of its actions in light of five "public interest" factors: (A) "protection of market participants and the

[25] These areas relate to CFTC Rules 4.25(c)(2)-(5) and 4.22(a). Harmonization NPRM, 77 Fed. Reg. at 11,346-48. Moreover, SEC staff has stated that it will consider requests for no-action relief. *Id*. at 11,347 n.26.

[26] If the allotted time is insufficient to prepare compliance, Plaintiffs may seek an exemption from the CFTC and/or seek relief from the SEC for the perceived conflict. *See* ICI Comment on Harmonization NPRM (Apr. 24, 2012) at 21 n.79 (citing SEC no-action letters), *available at* http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1161.

public"; (B) "efficiency, competitiveness, and financial integrity of futures markets"; (C) "price discovery"; (D) "sound risk management practices"; and (E) "other public interest considerations." 7 U.S.C. § 19(a). Plaintiffs argue that the CFTC failed to do so "meaningful[ly]" in the Final Rule (Mem. 20), but each of their criticisms proceeds from the same false premise: that securities and derivatives regulation "serve the same ultimate goals," which, Plaintiffs incorrectly represent, the "Commission itself acknowledged." (Mem. 22.) As discussed above and in the Final Rule, "[w]hile" the two regulators share "objectives" such as protecting "the public from fraud and manipulation," the CFTC "administers the CEA to foster *open, competitive, and financially sound commodity and derivatives markets*." Final Rule, 77 Fed. Reg. at 11,278 (emphasis added). Plaintiffs obviously cannot and do not contend that the SEC or FINRA does the same.

Here, as elsewhere, Plaintiffs ignore the primary basis for the Final Rule – that while "the Dodd-Frank Act has given the Commission a more robust mandate to manage systemic risk and to ensure safe trading practices by entities involved in the derivatives markets" including swaps markets, the CFTC currently has "no source of reliable information regarding the general use of derivatives by registered investment companies." Final Rule, 77 Fed. Reg. at 11,275; *see also id.* at 11,281 (explaining that these "final regulations are essential for the Commission to be able to fulfill" its role "as a member of FSOC and as a financial regulatory agency" charged "with mitigating risks that may impact the financial stability of the United States"). Nor does the SEC or any other regulator have that information. *See* SEC Release, 76 Fed. Reg. at 55,238 n.7 (cited in the Final Rule) ("[C]omplete data concerning the nature of derivatives activities of [RICs] is unavailable[.]"). Based on false premises, each and every one of Plaintiffs' criticisms of the CFTC's cost-benefit consideration is wrong. The Commission performed a thorough

consideration addressing each of the five statutory factors, satisfying all applicable standards, and, indeed, taking steps to reduce costs wherever reasonably possible.

A. The CEA Grants the CFTC Broad Discretion to Consider the Costs and Benefits of Its Regulations.

While no court has interpreted CEA Section 15(a), 7 U.S.C. § 19(a), when a statute requires an agency to "consider" enumerated factors, "consider" has its usual meaning, *i.e.*, to "take into account" the factors given, *Merriam-Webster's Collegiate Dictionary* 265-66 (11th ed. 2011), and the agency has discretion to weigh those factors according to its judgment. *See, e.g.*, *Brady v. FERC*, 416 F.3d 1, 5 (D.C. Cir. 2005) (Roberts, J.); *New York v. Reilly*, 969 F.2d 1147, 1150 (D.C. Cir. 1992). Cases Plaintiffs cite applying the SEC's governing statutes do not purport to disturb this principle. *See Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (stating that "arbitrary" and "capricious" standard applies); *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 177 (D.C. Cir. 2010) (same); *Chamber*, 412 F.3d at 142-43 ("APA" standard).[27]

As a threshold matter, the cited cases do not so much as mention the statute Plaintiffs claim the CFTC violated, Section 15(a) of the Commodity Exchange Act – rather, they concern "a unique obligation" on the part of the SEC arising under the securities laws "to assess the economic effects of a new rule" including "economic consequences" on, among other things, "'capital formation.'" *Bus. Roundtable*, 647 F.3d at 1148 (quoting the Securities Exchange Act and Investment Company Act). Thus, Plaintiffs incorrectly describe *Business Roundtable*,

[27] While *Business Roundtable* recited the APA standard, it did not pay the SEC deference as required under Supreme Court precedent. *Compare Fox Television Stations*, 556 U.S. at 513-14 ("a court is not to substitute its judgment for that of the agency" (internal quotation marks omitted)) *with Bus. Roundtable*, 647 F.3d at 1151 (criticizing the SEC for relying on "relatively unpersuasive studies"). In any event, the Final Rule here satisfies the standards articulated in *Business Roundtable*.

Chamber, and *American Equity* as establishing that "an agency" must assess "economic consequences" in the manner required of the SEC (Mem. 34) – they expressly do not establish any such categorical requirement.

While Plaintiffs emphasize the SEC's duty under *Business Roundtable* to "quantify" a rule's costs (*id*.), they insert an ellipsis in place of the D.C. Circuit's qualification that the agency need do so only as to "the *certain* costs," not uncertain or speculative costs. 647 F.3d at 1149 (emphasis added). Moreover, Plaintiffs admit that *Business Roundtable* acknowledges that even *economic* effects are not always quantifiable. (Mem. 34.) In those instances, the SEC need only provide a reasoned explanation. *Bus. Roundtable*, 647 F.3d at 1149. Here, although the securities laws do not apply, the CFTC met that standard – quantifying where such data was reasonably feasible to obtain and giving qualitative consideration to other issues.[28]

In the face of those facts, Plaintiffs attempt to assert that "arguably" the CEA imposes an "even more stringent" standard than discussed in *Business Roundtable* because Section 15(a) uses the word "evaluate" to introduce the five required "considerations" 7 U.S.C. § 19(a)(2). (Mem. 21.) But they make no attempt to explain what that could mean in this context, above and beyond the requirement applicable to the SEC to "quantify the certain costs" or explain why those costs cannot be quantified.[29] The CEA, rather than imposing a mechanical or mathematical test as Plaintiffs would require, lists public interest "considerations," most or all of which are

[28] Amicus MFDF relies heavily on an internal memo to CFTC staff by the Commission's General Counsel Dan Berkovitz and Chief Economist Andrei Kirilenko that is not part of the administrative record. Like the caselaw, the "Berkovitz Memo" states that "[c]osts and benefits should be quantified when it is reasonably feasible and appropriate to do so," but "in some areas quantification is not possible, and in these areas qualitative measures should be used."

[29] The drafters likely used "evaluate" rather than repeating "consider" so as to avoid the awkward phrasing that would result from requiring the Commission to "consider . . . considerations" (A) through (E). *See* 7 U.S.C. § 19(a)(1)-(2).

inherently not susceptible to quantification. *See, e.g.*, 7 U.S.C. § 19(a)(2)(A) ("protection of market participants and the public"); *id*. § 19(a)(2)(D) ("sound risk management practices"); *id*. § 19(a)(2)(E) ("other public interest considerations"). The Commission, therefore, "consider[ed]" and "evaluate[d]" all relevant information according to its broad discretion.

B. The CFTC Properly Considered the Costs and Benefits of the Finalized Registration and Financial Reporting Provisions.

1. As detailed above, the Final Rule aims to achieve a number of significant benefits. *See supra* Part I(A). The consideration of costs and benefits in the release discusses these at length, including: (1) eliminating informational blind spots in the derivatives markets, *see, e.g.*, Final Rule, 77 Fed. Reg. at 11,275, 11,277; (2) enabling the CFTC to carry out its systemic-risk prevention duties under Dodd-Frank, *see, e.g.*, *id*. at 11,275,11,281; (3) acquiring a direct and more effective means to address wrongful conduct by participants in the commodity derivatives markets, *id*. at 11,277; (4) enabling the CFTC to assist the FSOC in its mission, *see, e.g., id.*; (5) bringing offshore *de facto* commodity pools into compliance with applicable laws governing CPOs, *see, e.g.*, *id*. at 11,275,11,277; and (6) ensuring competency among derivatives-market participants, *see, e.g.*, *id*. at 11,277. The Commission considered these benefits in the context of the five Section 15(a) factors. *See id*. at 11,280-81 (applying the five factors to the registration provisions); *id*. at 11,281 (applying the five factors to the financial reporting provisions).

2. The Commission reasonably determined that systemic benefits of this nature cannot meaningfully be quantified. *See, e.g.*, *id*. (noting that "enhancing the quality of entities operating within the market" is "unquantifiable"); *id*. at 11,281 ("The total benefit of risk mitigation as it pertains to the overall financial stability of the United States is not quantifiable[.]"). Plaintiffs suggest no way in which such benefits could be monetized. But, as the Commission reasoned, these benefits are "significant insofar as the Commission may be able to use this data to prevent

further future shocks to the U.S. financial system." *Id*. at 11,281. That too is indisputable and not seriously contested by Plaintiffs. Further compounding the impracticability of quantifying these benefits is the fact that no regulator, or presumably any other source, has complete or reliable information concerning the use by RICs of derivatives including swaps. *See* SEC Release, 76 Fed. Reg. at 55, 238 n.7 (cited at Final Rule, 77 Fed. Reg. at 11,255 & n.36).

3. The Commission also considered the costs. With respect to registration, the Commission noted that CPOs will need to expend certain fees and a modest amount of time submitting forms to NFA. Final Rule, 77 Fed. Reg. at 11,273. There is a one-time $200 registration fee and an annual $750 dues payment for NFA membership; for each "associated person" required to register there is an $85 registration fee, a $15 fingerprinting fee, and a $90 Series 3 examination fee. 77 Fed. Reg. at 11,273, 11,277. The required forms need to be submitted only once in the life of a person or entity, 7 C.F.R. §§ 3.10(b), 3.12(b), and the Commission estimated that the average time to complete them, on an annualized basis, would be .9 hours. *See* 77 Fed. Reg. at 11,273-74. The Commission also noted the cost of undergoing an NFA audit, but explained that this cost "varies greatly by individual entity and individual audit" and thus "is difficult to quantify" meaningfully. Final Rule, 77 Fed. Reg. at 11,277. The Commission explained, however, that "[n]otwithstanding the difficulty of quantifying such a burden, . . . this cost will most likely arise in the first year of registration and on average every few years thereafter, and entities should expect [an audit] fee to be incurred." *Id*. The Commission also recognized that registration might result in certain additional costs that are not practical to quantify and would vary depending on the nature of the particular registrant. *Id.* (citing a commenter's discussion of factors such as compliance personnel, IT system modifications, and legal and accounting advice which, according to the commenter, would vary

significantly among firms). No RIC or association of RICs submitted quantitative data on the cost of registration.[30]

4. With respect to financial reporting, the Commission gave detailed estimates of the expected burdens of completing each of the three schedules of Form CPO-PQR. *Id*. at 11,275.[31] The Commission estimated 6 hours per Schedule A; 4 hours per schedule B (medium and large entities only); and 18 hours for the very largest CPOs to complete Schedule C. *Id*. The Commission published an initial version of these estimates in the NPRM. 76 Fed. Reg. at 7988. No commenter disputed these figures or submitted other quantitative cost estimates.

5. As part of its consideration of the costs and benefits, the Commission took appropriate steps to *mitigate* costs attendant to the Final Rule. Chief among these efforts is the Commission's decision to suspend affected RICs' substantive compliance obligations under Part 4 and to initiate a new rulemaking dedicated entirely to reducing costs. *Id*. The Commission separated those issues specifically so that such costs would *not* follow inexorably from registration. Plaintiffs' cost-benefit criticisms related to those requirements are therefore misplaced and, for the reasons given, unripe. *See* Part II, *supra*. The Commission will present its consideration under Section 15(a) for those areas when it issues a final harmonization rule.

The Commission also adopted numerous cost-mitigating measures in the Final Rule itself, all of which are ignored by Plaintiffs. For example, the alternative 100 percent net notional test is a burden-reducing measure adopted to "afford investment companies with

[30] Amicus MFDF faults the CFTC for failing to address the extent to which mutual funds would pass on to investors any costs imposed by the rule. (MFDF Br. 11.) Having adequately addressed the extent of the costs imposed on newly registered entities, however, the CFTC has no obligation to speculate as to the extent to which those funds will pass those costs on to their investors, and no such data was provided.

[31] In the discussion of Section 15(a) requirements in the Final Rule, the Rule 4.27 reporting requirements were sometimes referred to as "Data Collection." *See* 77 Fed. Reg. at 11,275.

additional flexibility in determining eligibility for exclusion." 77 Fed. Reg. at 11,279. So too is the tiered, three-schedule system in Form CPO-PQR. The CFTC explained that "smaller operators" are "less likely to present significant risk to the stability of the commodities futures and derivatives markets and the financial market as a whole," while large entities "are most likely to pose market and systemic risk." NPRM, 76 Fed. Reg. at 7978-79. It therefore adopted the tiered approach to "minimize[] the burden on smaller registrants." *Id*. at 7979. In the Final Rule, the Commission also: (1) increased the reporting thresholds from those in the NPRM, reducing the number of CPOs required to file Schedule C, 77 Fed. Reg. at 11,267; (2) reduced the frequency of reporting from the NPRM, *id*. at 11,269, 11,274; and (3) altered several Form CPO-PQR provisions from those originally proposed, *id*. at 11,270 (requiring a less detailed geographical breakdown of investments); *id*. (eliminating two questions); *id*. at 11,270-71 (in questions on risk metrics, adding a category of "relevant/not formally tested," so that "CPOs without existing quantitative models will not be required to build or acquire them"); *id*. at 11,271 (revising question on fixed income assets so that CPOs can "utilize their existing practices"). These and other cost-mitigating actions demonstrate that the Commission adequately "consider[ed]" the attendant costs, as required by Section 15(a), 7 U.S.C. § 19(a)(1).[32]

C. Plaintiffs' Specific Cost/Benefit Criticisms Have No Merit.

1. Plaintiffs base their criticisms on the incorrect claim that the CFTC "made no effort to determine the extent to which" allegedly "overlapping regulations pursue the same objectives" as SEC regulations. (Mem. 23; *see generally id*. 22-28). As discussed above and emphasized in the

[32] Market participants voiced support in the comment process for the balance struck by the CFTC. *See* Roundtable Tr. at 211 (representative of Franklin Templeton Investments stating "that's something [Forms PF and CPO-PQR] we could certainly live with" and "we're willing to give you what you need"); *id*. (representative of the Managed Funds Association stating that "we would echo that" support).

Final Rule, while the agencies share certain objectives, the Final Rule pertains directly to functions that they *do not* share – monitoring and protecting the *commodity derivatives* markets. 77 Fed. Reg. at 11,278.[33] Because Plaintiffs ignore this difference, most of their criticisms suffer from the same flaw and are irrelevant. (*See, e.g.*, Mem. 22 ("The final rule does not identify which SEC and FINRA regulations affect investment companies[.]"); *id*. at 23 ("Both regimes require registration, reporting, and disclosure"); ("both impose recordkeeping obligations"); *id* ("both require qualifications testing"); *id*. (asserting that certain SEC regulation "goes well beyond CFTC regulation of CPOs"); *id.* at 25 (citing "failure to compare" the CFTC's "regulations to those of the SEC").) Plaintiffs do not suggest how any of the areas of alleged overlap are relevant to the CFTC's duty to regulate derivatives trading activity in the markets within its exclusive or primary jurisdiction.

As a result, Plaintiffs misplace reliance on *American Equity*, 613 F.3d at 178 (Mem. 29), which held that the SEC failed to consider whether existing state regulation of *exactly the same activity* rendered federal regulation superfluous. *Id*. Here, the CFTC is regulating different activity in different markets. Nor did the CFTC "appeal to its authority" to "justify" the Final Rule. (Mem. 29) Rather, the Commission views the Final Rule as necessary to execute its *responsibility* under Dodd-Frank to "foster open, competitive, and financially sound commodity and derivatives markets," and the Commission articulated a reasoned explanation of why this is so. 77 Fed. Reg. at 11,275-83.

This special responsibility to oversee trading activity in its jurisdictional markets to guard

[33] Amicus MFDF repeatedly complains that the CFTC failed to focus on investor-protection benefits for mutual fund shareholders. (MFDF Br. 7-10, 14-15.) In fact, as the Commission explained, the Final Rule benefits investors. *See, e.g.*, 77 Fed. Reg. at 11,277 (discussing reparations procedures to help investors).

against systemic risk is an additional difference between this case and *Business Roundtable*. (Mem. 27.) There, the SEC promulgated unprecedented new rules for shareholder elections of corporate board members to "'improve[] board and company performance and shareholder value.'" 647 F.3d at 1147-48. With respect to RICs, the D.C. Circuit held that the SEC had failed even to consider that the Investment Company Act already provided some of the same protections the agency was citing as justification for imposing additional requirements. *Id*. at 1154-55. Here, in contrast, the CFTC is exercising authority it historically has exercised in commodity derivatives markets (from the agency's creation until 2003) and explained, based on its own past experience and other considerations, including the financial crisis and Congress' charge to the CFTC to become the primary regulator of the swaps markets, that its 2003 deregulation rule would be a hindrance to carrying out its mission.

2. Similarly, Plaintiffs ignore the rulemaking documents, the record, and all relevant context when they argue that the CFTC "failed to explain why, given the rules already on the books, there was any need for added regulation." (Mem. 22.) As discussed above, this contention is answered on virtually every page of the Final Rule. The CFTC determined that, because of the centrality of dark derivatives markets to the financial crisis and the Commission's duties under Dodd-Frank, it would be contrary to the public interest to continue excluding RICs on a blanket basis from the CFTC's monitoring of the markets within its jurisdiction. Final Rule, 77 Fed. Reg. at 11,275, 11,281. The Commission determined that this need to reassert its statutory authority is especially acute in light of the "dramatic" and "significant" increase in the use of derivatives by RICs in recent years. *See* 77 Fed. Reg. at 11,255 & nn.35-37 (quoting SEC statements). In that respect, Plaintiffs' contention that the CFTC did not "demonstrate that investment companies' participation in commodity markets was sufficiently widespread" borders

on the bizarre in light of *this lawsuit* to enjoin the Final Rule. (Mem. 24.) That curiosity aside, they ignore both the SEC's own statements on this issue, quoted in the release, as well as the limitation in the rules that only RICs engaged in a threshold amount of commodity derivatives trading need register.[34]

3. Also lacking merit is Plaintiffs' claim that the CFTC failed to explain why its 2003 cost-benefit analysis was no longer adequate. (Mem. 33-34.) The Commission explained that in 2003 it had no authority to regulate swaps under the CFMA, but that Dodd-Frank's expansion of the CFTC's jurisdiction in that regard rendered the earlier analysis irrelevant. *See* Final Rule, 77 Fed. Reg. at 11,252-54, 11,275. As also explained, the post-crisis CFTC has reached different judgments from the 2003 Commission, particularly regarding deregulation as a means to improve risk management.[35] *See id. at* 11,252-53.

4. Plaintiffs also contend that the Commission's analysis is flawed because the CFTC has yet to finalize a pending rule further defining "swap." With that rulemaking in progress, Plaintiffs contend that it is "impossible" to "meaningfully assess" the costs associated with the Rule. (Mem. 36.) Not so. Dodd-Frank established a detailed definition of "swap," Dodd-Frank § 721(a), 124 Stat. at 1666-68 (to be codified at 7 U.S.C. § 1a(47)), but directed the CFTC and

[34] Amicus MFDF argues that the CFTC failed to address a "cost" insofar as, in order to avoid registering with the CFTC, RICs would forgo otherwise profitable risk-management strategies involving derivatives. (MFDF Br. 17-20.) Plaintiffs appropriately do not raise this issue, and MFDF points to no commenter who did. With good reason – nothing in the Final Rule prevents a RIC from using derivatives, and it is illogical to believe that if the practice were profitable as MFDF contends, a RIC would halt its investments simply to avoid registering and reporting financial data. Of course, registration might discourage RICs from using derivatives in ways that might not withstand regulatory scrutiny, even if registration were costless. But that would be a benefit rather than a cost of the Final Rule.

[35] It is noteworthy as well that the cost-benefit analysis supporting the 2003 deregulatory rules that Plaintiffs champion was far less detailed than the analysis supporting the current Final Rule. It is doubtful that the 2003 Rule could survive the sorts of requirements Plaintiffs urge the Court to apply here.

SEC jointly to issue rules further defining that term, as well as "securities-based swap" and others, Dodd-Frank § 712(d)(1), 124 Stat. at 1644. Upon review, the Commissions determined that the statutory definition is "comprehensive," and that "extensive 'further definition' of the terms by rule is not necessary." Further Definition of "Swap," & Other Terms, 76 Fed. Reg. 29,818, 29,819-20 (proposed May 23, 2011). Accordingly, the agencies have proposed only limited clarifications to narrow the definition by *excluding* "certain types of agreements, contracts, and transactions, such as insurance products and certain consumer and commercial contracts," and to provide interpretive guidance. *Id*. at 29,821,

In that context, the CFTC in this Final Rule determined that no proposed or otherwise reasonably foreseeable change to the definition of "swap" would have a material impact on the Commission's judgment concerning whether to require registration of these RICs. 77 Fed. Reg. at 11,276. This is especially so in light of the fact that the benefits of the regulation are substantial, but not quantifiable, *id*. 11,281, while the costs the Commission has identified permissibly are estimates rather than precise measurements, *id*. at 11,276 ("all costs discussed herein are estimates"); *see Chamber*, 412 F.3d at142 (agency may base its analysis of costs and benefits on "informed conjecture"). No further clarity will be achieved by delay.[36] Moreover, as Plaintiffs do not dispute, an agency is entitled to promulgate rules in stages. *Am. Portland Cement Alliance*, 101 F.3d at 776.

5. While Plaintiffs assail the Commission for "failing to collect relevant market data"

[36] Likewise misplaced is Plaintiffs' criticism that this rule was promulgated before the final rule setting margins for uncleared swaps. (Mem. 15-16.) The forthcoming rule will have only prospective application and therefore will have no effect on the amount of initial margin and premiums that companies are currently required to pay on their existing contracts. Moreover, because Rule 4.5 allows companies to avail themselves of the alternative net notional test – which uses the notional value of contracts rather than margin amounts – the forthcoming rule on margins will have zero effect on the alternative net notional test.

(Mem. 35), Plaintiff ICI touts itself as "the primary source of aggregate industry data relied on by government agencies" and operating "an extensive research program." Compl. ¶ 6. In this rulemaking, the CFTC repeatedly requested all interested parties, including Plaintiffs, to provide all relevant information. Given Plaintiff ICI's active involvement throughout the rulemaking process, Plaintiffs can hardly complain that the Commission somehow failed to locate or create additional data that the self-described best source of such data did not offer.[37] In any event, the Commission did not need more data to take the prudent step of reasserting its indisputable authority over RICs operating in the CFTC's jurisdictional markets.[38]

6. While Plaintiffs critique the CFTC for using "platitudes," they ignore detail wherever it resides, making no mention, for example, of the Commission's thorough analysis of the specific information to be reported under Rule 4.27. *See* NPRM, 76 Fed. Reg. at 7980-82. An "extreme degree of deference" applies to technical judgments of this nature. *See Kennecott Greens Creek Mining Co.*, 476 F.3d at 954-55; *Community Nutrition Inst. v. Block*, 749 F.2d 50 (D.C. Cir. 1984) (Scalia, J.) ("courts must give great deference" to an agency's "expert and technical judgment").

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[37] Plaintiffs quote out of context a statement by a CFTC staff member that "Even though my training . . . would say you get the data first, I'm not seeing it in this current political and budgetary environment." (Mem. 36 (quoting Roundtable Tr. at 84).) The staff member explained, however, that there is a "chicken-and-egg problem" associated with the need to "collect the data first before you determine what policy you want to establish," because without registration the Commission had no means "to get the data if [it didn't] have the registrant." Roundtable Tr. at 80-81. Because interested parties provided only scant data, "it's been very hard to get at the cost benefit issues," but the Commission was committed to "make sure that we're as complete as possible on the cost benefit side of things." *Id*. at 147.

[38] Similarly, Plaintiffs are mistaken when they contend that the CFTC had an obligation to conduct a study before setting the exemption level at five percent. (Mem. 35-36.) An agency is not required to conduct a study before it acts, *see Chamber of Commerce*, 412 F.3d at 142, or to conduct a study prior to estimating the costs and benefits of a rule provision, *see Jifry v. FAA*, 370 F.3d 1174, 1180 (D.C. Cir. 2004) (where data do not exist, agency need only "so state, and go on to identify the considerations it found persuasive").

7. Plaintiffs also make the novel suggestion that FINRA's securities exam achieves the same purposes as the Series 3 derivatives exam. (Mem. 27.) While Plaintiffs point out that CFTC rules allow FINRA-registered individuals to solicit funds for commodity pools (Mem. 5), they ignore that these same regulations require at least one person of each CPO to register with the NFA and therefore to pass the Series 3. *See* 17 C.F.R. § 3.10(a)(2). Rather than demonstrating that "FINRA standards are sufficient" (Mem. 27), the regulations demonstrate that while securities-industry competencies may have some relevance, they are not a substitute.

8. Finally, Plaintiffs are mistaken to suggest that additional notice and comment was required on cost-benefit beyond that supplied in the NPRM. They base this assertion on nothing more than *added length* in the Final Rule versus the NPRM. (Mem. 44-45.) But the very case they cite, *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006), disposes of this argument, confirming that "further notice and comment are *not* required when additional fact gathering merely supplements information in the rulemaking record by checking or confirming prior assessments without changing methodology, by confirming or corroborating data in the rulemaking record, or by internally generating information using a methodology disclosed in the rulemaking record." *Id*. at 900 (emphasis added). Plaintiffs do not state any basis to conclude that the CFTC violated that standard, nor do they claim any prejudice, as they were required to do in order to state such a claim. *See Am. Coke & Coal Chems. Inst.*, 452 F.3d at 939.

IV. Plaintiffs' Prayer for Relief Is Overbroad and Unwarranted.

Plaintiffs seek to enjoin and vacate amended Rule 4.5 and Rule 4.27. *See* Pls' Proposed Order. Even if Plaintiffs' claims were meritorious, which they are not, such a sprawling injunction would be improper. The APA provides that a court may hold unlawful and set aside agency action, 5 U.S.C. § 706(2)(C), but "agency action" refers to specific provisions. *See* 5 U.S.C. § 551(13) (defining "agency action" to include "the whole or a part of an agency rule,

order, … or the equivalent"). "[C]ourts may 'set aside' only the part of a rule found to be invalid – for that is the only 'agency action' that exceeds statutory authority." *Catholic Social Serv. v. Shalala*, 12 F.3d 1123, 1128 (D.C. Cir. 1994). "It would, therefore, exceed the statutory scope of review for a court to set aside an entire rule where only a part is invalid, and where the remaining portion may sensibly be given independent life." *Id*.

Severability turns on the intent of the agency and whether the remainder of the regulation could function sensibly without the stricken provision. *K Mart Corp. v. Cartier*, 486 U.S. 281, 294 (1988). Because the CFTC gave independent reasons for the Rule 4.5 registration amendments, Plaintiffs' objections to financial reporting under Rule 4.27 would not be grounds to vacate or enjoin amended Rule 4.5 or vice versa. By similar token, Plaintiffs' objections to Rule 4.27 as it applies to them would not be grounds to disturb Rule 4.27 wholesale as to CPOs other than RICs – CPOs who are subject to different SEC regulations or no SEC regulations at all and who have not challenged the CFTC's registration and financial reporting provisions in this rulemaking. Vacatur would disrupt their preparations and create uncertainty regarding their legal obligations. *See Chamber*, 412 F.3d at 145 (remanding, but not vacating, after finding, *inter alia*, flaws in the rule's cost-benefit analysis). This Court has discretion to remand to the agency for correction, based on a balancing of the seriousness of the deficiencies and the disruptive consequences of an interim change that may itself be changed. *Chamber*, 443 F.3d at 908. Relief narrowly tailored to address Plaintiffs' claims with the least potential for larger disruption would be in order here because, whatever the reason the Commission's Final Rule conceivably could have fallen short, the authority of the CFTC to register CPOs regardless of their registration status with other agencies is longstanding and undisputed.

CONCLUSION

For the reasons presented, this Court should grant the Commission's Cross-Motion for Summary Judgment, deny Plaintiffs' Motion for Summary Judgment, and dismiss unripe claims.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on June 18, 2012, I filed Defendant Commodity Futures Trading Commission's Combined Cross-Motion for Summary Judgment, Opposition to Plaintiffs' Motion for Summary Judgment, and Motion to Dismiss in Part using this Court's CM/ECF electronic filing system. Also on June 18, 2012, I served these documents on the following counsel for Plaintiffs using the CM/ECF system:

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