(ORAL ARGUMENT NOT YET SCHEDULED)

**No. 12-5413**

**In the**
# United States Court of Appeals
**for the District of Columbia Circuit**

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INVESTMENT COMPANY INSTITUTE, *et al.*,
*Appellants*,

v.

UNITED STATES COMMODITY FUTURES TRADING COMMISSION,
*Appellee*.

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On Appeal from the U.S. District Court for the District of Columbia
No. 1:12-cv-00612-BAH (Hon. Beryl A. Howell)

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# BRIEF FOR THE MUTUAL FUND DIRECTORS FORUM AND FORMER COMMISSIONERS AND SENIOR OFFICIALS OF THE SECURITIES AND EXCHANGE COMMISSION AS *AMICI CURIAE* IN SUPPORT OF APPELLANTS

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February 6, 2013

## CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

### A. Parties

All parties appearing in this Court and before the district court are listed in the Brief for Appellants, except that this brief is filed on behalf of the Mutual Fund Directors Forum and former senior officials of the Securities and Exchange Commission: Chairman Richard C. Breeden; Commissioners Paul S. Atkins, Edward H. Fleischman, and Joseph A. Grundfest; and Directors of the Division of Investment Management Allan S. Mostoff, Paul F. Roye, and Marianne K. Smythe.

### B. Rulings Under Review

References to the ruling at issue appear in the Brief for Appellants.

### C. Related Cases

*Amici* adopt the statement of related cases presented in the Brief for Appellants.

## CORPORATE DISCLOSURE STATEMENT

The Mutual Fund Directors Forum ("Directors Forum") is a non-profit membership organization for the independent directors of investment companies. It has no parent corporation, and no publicly held company has a ten-percent or greater ownership interest in the Directors Forum.

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## GLOSSARY OF ABBREVIATIONS

| | |
|---|---|
| CEA | Commodity Exchange Act |
| CFTC | Commodity Futures Trading Commission |
| CPO | Commodity Pool Operator |
| FINRA | Financial Industry Regulatory Authority |
| FSOC | Financial Stability Oversight Council |
| ICI | Investment Company Institute |
| NFA | National Futures Association |
| SEC | Securities and Exchange Commission |
| SIFMA | Securities Industry and Financial Markets Association |

## STATUTES AND REGULATIONS

The Brief for Appellants contains pertinent statutes.

## INTEREST OF *AMICI CURIAE*[1]

*Amici curiae* are the Mutual Fund Directors Forum ("Directors Forum"), a former Chairman and Commissioners of the Securities and Exchange Commission ("SEC"), and former Directors of the SEC's Division of Investment Management. The Directors Forum is authorized by its board of directors to participate in this case. All parties have consented to the filing of this brief.

The Mutual Fund Directors Forum is a nonprofit membership organization established as a resource for the independent directors of mutual funds. The Directors Forum provides training and educational programs for directors, recommends improvements and best practices in mutual fund governance, and advocates for reforms and policy positions that serve the interests of directors and the shareholders they represent. Membership in the Directors Forum is limited to the independent directors of U.S. registered investment companies.

*Amici* former SEC Chairman, Commissioners, and Directors of the Division of Investment Management join this brief in their individual capacities based on their years of experience with the federal securities laws and the regulation of

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity other than *amici curiae*, members thereof, and their counsel contributed funds toward its preparation or submission.

investment companies. In their former roles as Chairman and Commissioners, *amici* supervised the drafting and implementation of securities regulations to ensure the protection of investors and the promotion of efficiency, competition, and capital formation. In their former roles as Directors of the Division of Investment Management, *amici* supervised the Division of the SEC responsible for regulating investment companies and advisers. Through their supervision of the regulation and examination of investment companies and advisers, *amici* are intimately familiar with the operation of mutual funds, their regulatory structure, and the interests of those who invest in them.

This brief reflects the views of all *amici* regarding the flawed process employed to promulgate the rule at issue, the SEC's robust regulation of investment companies and its oversight of their investments in derivatives, and the adverse impacts that the rule will have on the regulatory structure for investment companies and advisers. These various *amici* are joining together in one joint brief pursuant to the Court's briefing order, and accordingly not all *amici* necessarily endorse each subsidiary point included in the brief.

The former SEC officials joining this brief are as follows:

The Honorable Richard C. Breeden served as Chairman of the SEC from 1989 to 1993. Chairman Breeden is currently the Chairman of Breeden Capital

Management LLC, a registered investment adviser, and has served as an adviser or director of numerous regulated and non-regulated entities in the U.S. and Europe.

The Honorable Paul S. Atkins served as a Commissioner of the SEC from 2002 to 2008. Mr. Atkins is the Chief Executive Officer of Patomak Global Partners. He provides consulting services to investment companies and industry associations on issues unrelated to this case.

The Honorable Edward H. Fleischman served as a Commissioner of the SEC from 1986 to 1992. Mr. Fleischman is currently retired.

The Honorable Joseph A. Grundfest is the William A. Franke Professor of Law and Business at Stanford Law School and served as a Commissioner of the SEC from 1985 to 1990. Professor Grundfest is also founder and senior faculty at the Rock Center on Corporate Governance at Stanford University.

Allan S. Mostoff served as Director of the Division of Investment Management of the SEC from 1972 to 1976. Mr. Mostoff is of counsel at Dechert LLP and was the founding president of the Mutual Fund Directors Forum, where he remains a director emeritus.

Paul F. Roye served as Director of the Division of Investment Management of the SEC from 1998 to 2005. Mr. Roye is currently Senior Vice President of the Fund Business Management Group of Capital Research and Management

Company, a privately owned investment manager. In connection with this role, Mr. Roye serves on fund boards, including those of registered funds.

Marianne K. Smythe served as Director of the Division of Investment Management of the SEC from 1990 to 1993. Ms. Smythe serves as a consultant to a fund administrator.

Mutual funds, as registered investment companies, are governed by boards of directors that must include members who are independent of the fund's investment adviser. 15 U.S.C. § 80a-10(a); *see id.* § 80a-2(a)(19). The independent directors of a mutual fund are duty bound to guard the interests of the fund's shareholders. *See id.* § 80a-35; *id.* § 80a-10; *Burks v. Lasker*, 441 U.S. 471, 480-84 (1979). They bear a special responsibility to shareholders, without regard to the interests of the investment advisers. *See* Robert A. Robertson, *Fund Governance: Legal Duties of Investment Company Directors* 2-52 (2007). The Supreme Court has recognized that the statutory requirement that a mutual fund's board include independent directors is "[t]he cornerstone of the Investment Company Act's effort to control conflicts of interest within mutual funds," *Burks*, 441 U.S. at 482; *see also Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1427-28 (2010).

As fiduciaries and representatives of the shareholders who are the owners of a mutual fund, independent directors are particularly attentive to significant changes in regulatory requirements that increase the costs to shareholders of operating the fund or reduce the fund's ability to implement the best investment strategies most efficiently, especially where the benefits of the regulatory change for shareholders may be insubstantial.

Having dedicated substantial portions of their careers to federal securities regulation, *amici* former SEC Chairman, Commissioners, and Directors of the Division of Investment Management join this brief to advise the Court on their views of the regulatory process employed by the Commodity Futures Trading Commission ("CFTC" or the "Commission") in this matter and on the impact that that rulemaking process will have on the regulatory scheme for investment companies. Like the independent directors, the former SEC officials have an interest in the efficacy of investment company oversight, which directly affects tens of millions of Americans who invest in mutual funds.

The Directors Forum and former SEC officials submit this brief to assist the Court in understanding how the CFTC's rule change will impact mutual funds and their investors.[2] The Commission's decision to reverse its position and require a much broader range of mutual fund investment advisers already registered with the SEC to register separately as commodity pool operators ("CPOs") (hereinafter

[2] The Directors Forum participated as a commenter in the rulemaking proceedings below, *see* A-1103 (Comments of the Directors Forum (Apr. 12, 2011)), and as *amicus curiae* in the district court.

"dual registration") will impose significant new costs on mutual funds. These costs will inevitably be passed along to shareholders, and the CFTC has not shown what, if any, benefits will accrue to investors given existing SEC regulatory oversight. The new rule will also negatively impact mutual funds' abilities to implement the most efficient and beneficial investment strategies for shareholders.

The Commission failed to quantify these additional regulatory costs or to consider their impact on investors. From our experience, the costs will be significant. The Commission also failed to explain how the dual registration burden will be offset by any corresponding direct regulatory benefits over and above the investor protections already encompassed by the SEC's registration and disclosure authority. For these reasons, *amici* agree with Appellants that the Commission's decision to amend 17 C.F.R. § 4.5 ("Rule 4.5") was arbitrary and capricious and failed to satisfy the cost-benefit analysis required by the Commodity Exchange Act ("CEA"), and the Court should therefore reverse the judgment of the district court.

## BACKGROUND

Nearly half of all American families invest in mutual funds, including more than 50 million households and more than 90 million individuals. *See* Investment Company Institute, *2012 Investment Company Fact Book: A Review of Trends in the U.S. Investment Company Industry* 87 (2012) ("ICI Fact Book"). Mutual fund shareholders range the gamut, from large institutions to individuals who purchase shares directly or invest indirectly through employee benefit plans to save for retirement. Because of their diversified asset bases and managed risk portfolios, and because they generally offer lower transaction costs than individual stock and bond trading, mutual funds are the preferred choice of millions of Americans for the investment of their retirement and college savings accounts and for other long-term, stable investment strategies.

Mutual funds have operated within a highly regulated framework since 1940. All mutual funds are registered investment companies subject to regulation by the SEC under the Investment Company Act of 1940, as amended. This regulation includes public registration and disclosure obligations, oversight by a board of directors typically composed of a majority of independent members who are specially charged with safeguarding the interests of shareholders, and other regulatory requirements and protections administered and enforced by the SEC. *See* 15 U.S.C. §§ 80a-1 to 80a-64; 17 C.F.R. pt. 270 (2012). The investment advisers to mutual funds are also already subject to registration, recordkeeping, examination, and other regulatory requirements by the SEC under the Investment Advisers Act of 1940, as amended. *See* 15 U.S.C. §§ 80b-1 to 80b-21; 17 C.F.R. pt. 275 (2012). The underwriters and distributing broker-dealers for mutual funds are registered with the SEC under the Securities Exchange Act of 1934 (codified at

15 U.S.C. § 78a *et seq.*), and are further subject to the oversight of the securities industry self-regulatory organization, the Financial Industry Regulatory Authority, or "FINRA," *see* FINRA Rules, *available at* http://finra.complinet.com. Finally, just like all market participants, mutual funds are required to file disclosures with the CFTC when they engage in certain large trades in the commodity markets, *see* 17 C.F.R. § 4.18 (2012), are subject to recently promulgated regulations imposing recordkeeping and reporting obligations for entities engaging in swap transactions, *see* CFTC, Swap Data Recordkeeping and Reporting Requirements, Final Rule, 77 Fed. Reg. 2,136 (Jan. 13, 2012); CFTC, Real-Time Public Reporting of Swap Transaction Data, Final Rule, 77 Fed. Reg. 1,182 (Jan. 9, 2012), and are subject to other trading regulations, as well as the antifraud provisions of the CEA, *see* 7 U.S.C. § 6b.

In 2003, the CFTC made a considered decision to exclude registered investment companies, including mutual funds, and their registered advisers from separate registration as commodity pool operators under the Commodity Exchange Act, precisely because they are already subject to comprehensive regulation under the SEC's broad registration and disclosure regime. *See* A-611 (CFTC, Notice of Proposed Rulemaking, Additional Registration and Other Regulatory Relief for CPOs, 68 Fed. Reg. 12,622, 12,625 (Mar. 17, 2003)). Thus, the Commission concluded in 2003 that shareholders of registered investment companies would benefit from a CPO exclusion by gaining "greater flexibility" and "efficiency" in their investment choices, while the entire market would benefit from "increased liquidity," and the Commission concluded that these benefits would come with "no decrease in the protection of market participants and the public" because registered investment companies are "otherwise regulated" by the SEC. *Id.*; A-600 (Notice of Final Rulemaking, 68 Fed. Reg. 47,221, 47,230 (Aug. 8, 2003)).

In the rulemaking at issue here, the Commission reversed course and substantially narrowed Rule 4.5's exclusion. A-285 (CFTC, Notice of Final Rulemaking, Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 77 Fed. Reg. 11,252 (Feb. 24, 2012)). The new rule will require mutual fund investment advisers to register as commodity pool operators if the fund invests in commodity futures, options, or swaps with "aggregate initial margin and premiums" that exceed five percent of the liquidation value of the fund's portfolio (after adjusting for any unrealized profits or losses on those positions), unless the adviser can demonstrate that these commodity investments are for "bona fide hedging" purposes only, as narrowly defined in 17 C.F.R. §§ 1.3(z) and 151.5 (2012). *See* A-316. The new rule also includes an alternative exclusion if the "aggregate net notional value" of the fund's non-bona fide hedging commodity positions does not exceed 100 percent of the liquidation value of the fund's portfolio. *See id.* Even if the fund's commodity investments do not exceed the thresholds, registration will still be required if the fund is promoted to the public as a vehicle for trading in the commodity markets. *Id.*

As a practical matter, the CFTC's new CPO registration regime for mutual fund advisers will actually be substantially broader than the registration requirements in place prior to 2003: It will be triggered not only by commodity futures or options trading (as under the pre-2003 rule), but also by trading in "swaps," a term that encompasses a broad new category of instruments not limited to commodity-based investments.[3]

## SUMMARY OF ARGUMENT

In amending Rule 4.5, the CFTC failed to account for and justify the impact its rule change will have on the most important constituency in the mutual fund industry—shareholders of mutual funds. By failing properly to analyze and weigh the costs and benefits of the rule change, particularly for shareholders, the Commission acted arbitrarily and capriciously and failed to satisfy the requirements of the Commodity Exchange Act.

*First*, the Commission failed adequately to quantify the increased costs from the dual registration regime. Operating costs will rise for mutual fund advisers that

[3] *See* CFTC, Further Definition of "Swap,'' "Security-Based Swap,'' and "Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Final Rule, 77 Fed. Reg. 48,208 (Aug. 13, 2012).

have previously been excluded from registration as CPOs, and these added operating costs will be passed on to shareholders directly in the form of higher mutual fund expenses. Costs incurred by registered investment advisers as a result of the new registration regime will also likely be passed on to shareholders indirectly, through higher management fees.

Not only will the dual registration regime increase costs, the Commission completely failed to explain how the creation of a dual registration and disclosure regime would add any new investor protection or other benefits to justify the increased costs to the existing pervasive regulation of mutual funds and their investment advisers by the SEC. In the district court, the CFTC framed the expected benefits of the new rule almost entirely in terms of the agency's own institutional interest in gaining a new stream of information. *See, e.g.*, Doc. 15 at 21-22. But the CFTC would be able to obtain any needed information about the market activity of mutual funds from the SEC without the need for any costly new registration regime. Nor does the CFTC need a registration regime to obtain information concerning investments in derivatives: Recent CFTC rulemakings enacted pursuant to the Dodd-Frank Act mandate extensive swap-related reporting from all market participants, including investment companies, and if necessary the CFTC could develop additional information-gathering measures without subjecting investment companies to the burdens of CPO registration.

*Second*, the CFTC did not recognize that by requiring CPO registration for mutual fund advisers whose investments in commodity futures, options, or swaps exceed an arbitrary minimum threshold (most particularly, five percent of the liquidation value of the fund's portfolio), even where the fund is not marketed as a means to trade in commodity instruments, the new rule will inevitably lead to a reduction in the variety of investment strategies that a mutual fund can efficiently offer. This loss of efficiency and diversification will impose real costs on shareholders by diminishing their ability to use the fund for managing risk and volatility and preserving liquidity. Tens of millions of American investors may be affected through diminished investment returns because their funds may limit their activities. The Commission acknowledged these costs in 2003. The CFTC found then that subjecting mutual fund advisers to potential CPO registration had limited fund trading activities, and thus the investment strategies available to investors, to a much greater extent than intended, because many advisers refrained from investing in commodities markets to avoid dual registration. *See* A-611.

The failure to consider and adequately analyze and account for these costs and the lack of offsetting benefits for shareholders of mutual funds renders the Commission's adoption of the challenged rule contrary to the express cost-benefit analysis provisions of the CEA, 7 U.S.C. § 19(a), and arbitrary, capricious, or otherwise not in accordance with the law in violation of the Administrative Procedure Act, 5 U.S.C. §§ 702, 706(2)(A), (C).

## ARGUMENT

### I. THE CFTC ACTED ARBITRARILY AND CONTRARY TO LAW BY ADOPTING THE NEW RULE WITHOUT ADEQUATELY CONSIDERING THE COSTS FOR MUTUAL FUND SHAREHOLDERS AND THE ABSENCE OF OFFSETTING REGULATORY BENEFITS

The Commission acted arbitrarily and contrary to the Commodity Exchange Act in amending Rule 4.5 because it failed to consider and quantify the costs the new rule will generate for shareholders, and it failed to identify additional regulatory benefits from dual registration for fund investors. *See Bus. Roundtable v. SEC*, 647 F.3d 1144, 1154-56 (D.C. Cir. 2011).

Section 15(a) of the CEA, 7 U.S.C. § 19(a), requires the Commission to "evaluate" the "costs and benefits" generated by a proposed rule in light of five "considerations": (A) "protection of market participants and the public"; (B) "the efficiency, competitiveness, and financial integrity of futures markets"; (C) "price discovery"; (D) "sound risk management practices"; and (E) "other public interest considerations." *Id.* § 19(a)(1) & (2). Consistent with the established approach of courts and the executive branch, a sound cost-benefit analysis, as contemplated by section 15(a), requires the Commission to quantify, to the extent reasonably feasible, the material costs expected to result from compliance with the new regulation and to weigh those costs against the expected benefits. *See Bus. Roundtable*, 647 F.3d at 1148-49.

Thus, an internal memorandum, issued by the CFTC's general counsel to guide rulemaking teams in analyzing costs and benefits under section 15(a), advises that "[c]osts and benefits should be quantified when it is reasonably feasible and appropriate to do so." Staff Memorandum from Dan M. Berkovitz, General Counsel, CFTC, to CFTC Rulemaking Teams 7 (May 13, 2011), *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/oig_investigation_061311.pdf, Ex. 2 ("Berkovitz Mem."). This guidance directs the staff to follow the cost-benefit principles laid down in Executive Order 13,563, issued by the President on January 21, 2011, to the extent "consistent with section 15(a)," *id.* at 1, and it notes that the Order requires agencies (consistently with section 15(a)) "to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible," and to "select the alternatives that maximize net benefits." *Id.* at 2-3 n.5 (quoting Exec. Order No. 13,563, 76 Fed. Reg. 3,821 (Jan. 21, 2011)). Just two months after the Berkovitz memorandum instructed the Commission to follow Executive Order 13,563, the President signed Executive Order 13,579, which extended the earlier Order to independent regulatory agencies like the CFTC. *See* Exec. Order No. 13,579, 76 Fed. Reg. 41,587 (July 14, 2011).

The record here makes clear that the Commission did not fulfill these requirements in adopting the new rule.

### A. The CFTC Failed to Account for and Justify the Regulatory Costs that a Substantial Narrowing of the Rule 4.5 Exclusion Will Impose on Mutual Fund Shareholders

The broad new CPO registration requirements the amendment to Rule 4.5 creates will impose a variety of significant costs on mutual funds and their advisers, and costs will predictably flow through to the funds' shareholders. *See generally* A-237, 244 (Compl. ¶¶ 25, 33(c)) (cataloging categories of costs new Rule 4.5 imposes). The Commission itself itemized many of these same burdens when it decided in 2003 to exclude mutual funds and their registered advisers altogether from CPO registration. *See* A-592. In the present rulemaking, however, the Commission neglected to give sufficient consideration to these costs.

The Commission acknowledged generally that the new rule will result in "significant costs" for the mutual fund industry, A-316, but the Commission made no effort to itemize or quantify significant components of these costs.[4] This failure was contrary to section 15(a) and Executive Order 13,563, as interpreted and

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[4] The district court accepted as sufficient that the Commission did not quantify some of the resulting costs but merely "recognized" that they would be incurred. *See* A-75 (citing 77 Fed. Reg. at 11,277); *see also* A-95 ("[T]he CFTC . . . provided estimates of *some* aspects of those registration costs . . .") (emphasis added). By failing to quantify even costs it did identify, the Commission made no effort to "determine as best it [could] the economic implications" of the rule. *See Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005).

applied to the Commission by the general counsel's memorandum, and as extended to cover the CFTC and other independent regulatory agencies by Executive Order 13,579. Executive Order 13,563 itself provides examples of "values that are difficult or impossible to quantify" in rulemaking, and they include intangible factors like "equity, human dignity, fairness, and distributive impacts." 76 Fed. Reg. at 3,821. Most of the financial costs of compliance involved here, on the other hand, are concrete and not at all intangible.

As a basic matter of fund accounting, several of these costs will have to be treated as operating expenses of the fund and, as such, will be added directly to the expenses borne by shareholders.[5] Potential costs include: (a) making monthly reporting statements to shareholders, along with an annual report to shareholders and to the commodity industry's self-regulatory authority, the National Futures Association ("NFA"), 17 C.F.R. § 4.22; (b) modifying existing disclosure documents, subject to the CFTC's Part 4 disclosure requirements, *id.* at §§ 4.21, 4.24-25; (c) filing additional disclosure documents with the NFA, 17 C.F.R. § 4.26(d); and (d) becoming subject to substantively duplicative but operationally different record-keeping requirements, *id.* at § 4.23. The final rule also adds a new reporting obligation for many CPOs by amending 17 C.F.R. § 4.27 and imposing a

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[5] Such direct operating costs of a mutual fund are included in the fund's fee table as "Annual Fund Operating Expenses—Other Operating Expenses" and are periodically deducted from the shareholder's investment gains.

new quarterly reporting requirement. *See* A-318-19. These direct operating costs will further include the necessary associated expenses of upgrading the fund's reporting and compliance systems and hiring the additional compliance personnel and counsel needed to monitor compliance with the CFTC's separate registration and disclosure regime. *See* A-974-75 (Comments of the Investment Company Institute (Apr. 12, 2011) ("ICI Comments") at 11-12).

Other compliance costs may not appear in the fund's fees as direct operating expenses, but will nevertheless have a quantifiable financial impact on the fund's investment adviser. Such "adviser-level costs" will include (a) filing fees paid to the NFA, (b) costs for employees to take certifying examinations required by the NFA, (c) certain legal fees, such as legal fees incurred in determining whether a particular fund qualifies for an exclusion (which must be determined separately for each fund), and (d) monitoring costs to ensure that the ongoing activities of exempt funds do not trigger the registration requirement. Such adviser-level costs, too, will likely ultimately be borne by mutual fund shareholders, since these costs can be expected to be passed on through higher management fees for new mutual funds and pressure to increase fees on existing funds. *See* SEC Staff, *Study on Investment Advisers and Broker-Dealers* 162 (Jan. 2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

One principal reason why the Commission made no effort to quantify these compliance costs in adopting the amendment to Rule 4.5 is because the full extent of the costs is not yet knowable given the Commission's flawed rulemaking process. When the Commission adopted the amendments, it had not yet finalized the definition of "swap," and the universe of registered companies subject to the new rule and the manner in which the rule will apply to particular funds and their advisers will not be established until the Commission establishes margin requirements for swaps and completes its rules purporting to harmonize CPO disclosure, reporting, and recordkeeping requirements and SEC regulatory obligations. *See* A-305, 310. This timing problem results from the Commission's own agenda for staging interrelated rulemakings; it cannot convert concrete costs into intangible costs, and it does not excuse the agency from satisfying section 15(a)'s requirements. *See Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005).[6]

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[6] The district court distinguished *Chamber of Commerce* on the ground that the CFTC did estimate actual costs "where it was possible" and that the CFTC "identified the *source* of additional costs." A-99 (emphasis added). However, *Chamber of Commerce* faulted the SEC for failing to "hazard a guess" for a *per fund* cost estimate where the SEC argued estimation was impossible because it did not know how funds would comply or what percentage would be affected. *See* 412 F.3d at 143-44. Here the CFTC both failed to identify all costs it reasonably could have, and, for costs it did "identif[y]," it failed to hazard a guess as to their economic impact *per fund* affected.

Apart from failing to quantify compliance costs, the Commission did not even acknowledge that these costs will be passed along to shareholders. That omission flies in the face of section 15(a), which expressly requires the Commission to evaluate costs and benefits in light of a rule's impact on "market participants and the public," 7 U.S.C. § 19(a)(2)(A).[7] It is also contrary to the general counsel's memorandum, which specified that the section 15(a) analysis must consider all costs that are "potentially significant to the public, the economy, the markets, and interested persons." Berkovitz Mem. at 6. There are no persons more "interested" in the costs generated by the Commission's rule change than the shareholders of those registered investment companies that will become subject to dual registration, as well as those that restrict their investments to avoid the rule. Those shareholders will now bear the costs, and these added costs will come out of the investment funds intended for retirement, college tuition, and rainy day purposes of millions of Americans. *See* ICI Fact Book at 87 (reporting that 94% of

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[7] Before the district court, the CFTC argued that no data on costs to shareholders had been provided to it and that it "has no obligation to speculate" about such costs, *see* Doc. 15 at 56 n.30, but this excuse ignores the statutory obligation, which requires the agency to try to quantify any identifiable costs. *See Pub. Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209, 1221 (D.C. Cir. 2004) ("The agency's job is to . . . hazard a guess . . . ."). The district court accepted the CFTC's estimates of "*some* aspects" (emphasis added) of registration costs alone as satisfying the analysis section 15(a) requires. *See* A-95.

mutual fund investors are saving for retirement, 48% are saving for emergencies, and 24% are saving for education).

The CFTC's total failure to quantify and consider these impacts on investors was arbitrary, capricious, and contrary to its statutory requirements.

### B. The CFTC Failed to Establish that Dual Registration Will Confer Any Benefits on Mutual Fund Investors

In adopting the amendments, furthermore, the Commission conducted no satisfactory evaluation establishing that the costs imposed on shareholders by the new dual registration requirement will be offset by any regulatory benefits. Indeed, the Commission refrained from even attempting to quantify any of the supposed benefits of its rule—which it simply declared "unquantifiable." A-310; *see id.* at A-314. Instead, the Commission asserted, and the district court accepted, *see* A-95, that CPO registration would serve the interests of investors by promoting "minimum standard[s] of fitness and competency" for registered entities (*i.e.*, fund advisers), and that prospective investors would "have the knowledge that such entities are held to high financial standards through periodic account statements, disclosure of risk, audited financial statements, and other measures designed to provide transparency to investors." A-313. However, the advisers who will be required to register with the CFTC are already subject to analogous SEC standards. Despite the CFTC's vague assertions of benefits, it is far more likely that these overlapping requirements will exacerbate confusion for investors. It is thus unsurprising that the record lacks evidence that the dual registration burden will confer benefits on shareholders that SEC oversight could not provide, as the CFTC acknowledged in 2003.

The Commission's proffered benefits are already realized for mutual fund investors by virtue of the SEC's long-standing registration, disclosure, examination, and enforcement regime under the Investment Company Act and the Investment Advisers Act. Contrary to the suggestion that investors need additional regulation to ensure "minimum standard[s] of fitness and competency" for funds, mutual funds are already "the most strictly regulated segment of the U.S. securities industry." Robert Pozen and Theresa Hamacher, *The Fund Industry: How Your Money Is Managed* 18 (2011). As part of its detailed regulation of mutual funds, the SEC has jurisdiction to review and regulate all fund investments, including those in commodities and derivatives.

Not only does the SEC have such authority, but it has been active in considering such issues pursuant to its mission to protect mutual fund investors. *See, e.g.*, SEC, Use of Derivatives by Investment Companies Under the Investment Company Act of 1940, 76 Fed. Reg. 55,237 (Sept. 7, 2011) (request for public comment on "wide range of issues relevant to the use of derivatives by funds"). The fact of SEC registration and regulation was essential to the Commission's creation of the 2003 exclusion. *See* A-609. In reversing its policy and the 2003 exclusion, the Commission did not find, and had no basis to find, that SEC regulation has been inadequate, nor did it adequately explain how the benefits it identified from the amendments are distinct from the benefits SEC regulation already confers.[8]

The district court accepted the CFTC's argument and distinguished *American Equity Investment Life Insurance Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2009), on the ground that the CFTC had adequately explained the benefits of the amendments by pointing out that the SEC's approach to derivatives issues was evolving and that the two agencies shared different regulatory objectives. *See* A-67-68; *see also* A-95. But these arguments are irrelevant to whether the proposed amendments offer real benefits over existing regulations. The Commission never identified a deficiency in the SEC regime that the amendments would correct, nor do the benefits to investors it identified have any connection to the varying regulatory missions of the CFTC and SEC.

Moreover, if anything, the CFTC's addition of a new layer of registration and disclosure obligations on top of the existing SEC regime will certainly produce

[8] As a concern prompting the amendments, the Commission did cite the NFA's comments asserting that three registered funds had been marketed to investors as "de facto commodity pools while claiming exclusion under § 4.5," A-287, but the Commission never found that these or other funds posed a threat to the investing public, and in any event the amendments go "far beyond" addressing that issue, *see* A-376 (Dissenting Statement of Commissioner Sommers).

unnecessary confusion for investors from differing disclosures. As noted by commenters, "additional disclosure" that provides "similar but non-identical information at different times, in different formats, and to different agencies w[ill] cause investor confusion." A-244 (Compl. ¶ 33(b)) (citing Comments of Janus Capital Management (Apr. 12, 2011) at 2). The SEC, over the course of decades, has developed detailed disclosure requirements for registered investment companies and advisers that ensure comprehensible and consistent information for investors across different types of investment funds. The new disclosure documents required by the CFTC, to the extent public, will be unfamiliar to mutual fund investors, will not conform precisely to SEC standards (otherwise, the CFTC would simply rely on SEC disclosures), and will likely adversely affect investors' ability to compare the investment strategies of different mutual funds.

The absence of any meaningful investor protection benefits leaves only the CFTC's suggestion that the purpose of the rule change was to advance the agency's own parochial interest in becoming a more active participant in an as-yet undefined Financial Stability Oversight Council ("FSOC") process, *see* A-285, without any explanation as to how the amendments advance the Commodity Exchange Act's purposes. As commenters noted, however, any such institutional interest can be met through simple information sharing between the SEC and the CFTC. *See* Comments of Invesco (Apr. 12, 2011) at 5; A-1064 (Comments of

Dechert LLP (Apr. 12, 2011) at 10). The Commission never explained why such information sharing would be unworkable.[9]

Information disclosed to the SEC by registered investment advisers is easily obtainable by the CFTC from the SEC. All mutual fund disclosure and reporting to shareholders is publicly available on the SEC's online EDGAR system. To the extent the CFTC believes it needs nonpublic information about commodity trading strategies or information in a particular form that is different from the disclosures the SEC mandates, an easier and less burdensome way to acquire it would be to work with the SEC to fulfill its information needs by incorporating certain disclosures into SEC-mandated forms without introducing a costly dual registration regime. The CFTC has neither identified a gap in existing information collected by the SEC nor asked the SEC to collect additional information.

And to the extent the Commission requires particular information about any significant commodity trading activity of mutual funds, it already receives such information through separate authority: Commenters noted that the CFTC can

[9] Elevating turf over government efficiency, the Commission has argued in this litigation that this approach would be unreasonable because the SEC would not agree to expend its own resources to "monitor[] risks posed to the derivatives markets by commodity pool operators," *see* Doc. 15 at 44, but it is implausible to believe the SEC would not be willing to incorporate the CFTC's information needs into its reporting requirements. The SEC and CFTC have an agreement to facilitate regulatory action in areas of common regulatory interest. *See* Memorandum of Understanding Between the SEC and CFTC (Mar. 11, 2008), *available at* http://www.sec.gov/news/press/2008/2008-40_mou.pdf.

gather extensive information through swaps-related reporting regulations recently promulgated under the Dodd-Frank Act, which apply generally to all market participants. *See, e.g.*, A-906 (Comments of Fidelity (Apr. 12, 2011), at 2). In addition, all market participants, regardless of registration status, that engage in large trades of commodity futures and options are required to make large trader reports to the CFTC on Form 40. *See* 17 C.F.R. § 18.00 (2012). The Commission also maintains authority to issue special calls for information about particular trading accounts from commodity market participants. *See* 17 C.F.R. pt. 21 (2012). Moreover, if existing disclosures were inadequate, additional reporting could be required without subjecting investment companies and advisers to additional registration burdens. *See* A-846 (ICI Comments at 7). The Commission has not provided a reasoned justification for rejecting these alternatives; it failed even to address the possibility of a narrow, information-gathering-only alternative, and objected to the suggestion that it proactively use special call authority by stating only that it has "generally" not done so in the past and that the authority was not originally intended to be used regularly. *See* Doc. 15 at 46 (quoting 77 Fed. Reg. at 11,261); A-312.

In the present rulemaking, the Commission never explained why these alternative sources of information cannot be developed to meet the FSOC purposes it wishes to advance.

## II. THE CFTC NEGLECTED TO RECOGNIZE THAT CPO REGISTRATION WILL HARM INVESTORS BY REDUCING THE AVAILABILITY OF DIVERSIFIED RISK MANAGEMENT STRATEGIES OFFERED BY MUTUAL FUND ADVISERS

Mutual funds have adapted to the volatile economic environment in recent years by offering their shareholders efficient and prudent opportunities to invest in futures, options, and other derivatives as part of a well-diversified investment strategy to manage risk, hedge against inflation and volatility, and preserve liquidity. By imposing an arbitrary cap on the portion of a fund's holdings the adviser can invest in these instruments without triggering the burdens of dual registration as a CPO, the new rule will reduce the ability of advisers to offer such strategies efficiently to the shareholders of existing mutual funds and will therefore inevitably lead to a reduction in the investment value of a fund for shareholders. The Commission and district court completely ignored this category of significant regulatory costs, even though the Commission's original decision to adopt the exclusion for registered investment companies in 2003 was justified by the need to avoid just such negative effects for investors.[10]

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[10] The CFTC's choice of the 5% trading threshold for registration was arbitrary. It is not based on any analysis of current trading practices, but on a 25-year-old review of initial hedge margins and premiums in commodity transactions. *See* A-868 (Comments of the Securities Industry and Financial Markets Association (Apr. 12, 2011) ("SIFMA Comments") at 8). The Commission itself seemed to recognize that the 5% threshold is too restrictive for today's investment strategies, since it acknowledged that "margin levels for securities product futures

In times of economic uncertainty, investors seek diversified investment opportunities to nurture their retirement accounts and other personal savings. Investors have different risk tolerances depending on their investment strategies and goals, ICI Fact Book, *supra*, at 29-30, and they often choose mutual funds specifically for their diversified portfolios. Investors may choose products that manage risk to their desired specifications within a particular fund, or they may choose to carry a portfolio of funds, each offering exposure to different types of investments, in order to achieve a desired balance. As the CFTC has noted, the benefits of diversifying stock and bond portfolios with physical commodity investments are well-recognized. *See* Risk Management Exemption from Federal Speculative Position Limits, 72 Fed. Reg. 66,097, 66,098 (proposed Nov. 27, 2007) (to be codified at 17 C.F.R. pt. 150).

Since the adoption of the Commission's unconditional exclusion for registered investment companies in 2003, fund advisers have responded to these needs by developing diverse, efficient investment strategies, some including exposure to commodities instruments and other derivatives, that help manage risk and help investors find value within different risk-tolerance profiles. A-980 (ICI Comments at 17). Like all mutual fund investments, such strategies are subject to

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are significantly higher" than 5%, and "levels for swaps margining may be as well." A-289.

oversight by the independent directors of mutual funds. *See* Directors Forum, *Risk Principles for Fund Directors* (April 2010), *available at* http://www.mfdf.org/director_resources/resource/risk_principles_for_fund _directors_april_2010/. The independent directors represented by *amicus* the Directors Forum "have found that the use of derivative instruments by experienced investment advisers with appropriate infrastructure to manage the investments can serve the best interests of retail investors." A-1105.

Funds often use investments in "swaps, futures, and options as a means to efficiently manage their portfolios, rather than as part of operating a commodity fund." A-980 (ICI Comments at 17). Commodities and related investments are used, for example, to manage cash and bond positions, make adjustments in the duration of portfolios, and hedge against inflation or foreign exchange movements. *Id.*; A-871 (SIFMA Comments at 11). These and other strategies can be used efficiently to balance risk across a portfolio of investments.

The amendment to Rule 4.5 will fundamentally alter this landscape by imposing added registration costs when fund advisers offer shareholders strategies that involve investments in commodity products and derivatives. The Commission specifically found just such a financial burden to be "too restrictive" when it adopted the 2003 exclusion. *See* A-225 (Compl. ¶ 3); A-968 (ICI Comments at 5). The new rule, however, will create an even greater financial burden on the ability of advisers to offer a variety of investment strategies than existed prior to the 2003 exclusion, since the new rule will count positions in swaps against the arbitrary five-percent and alternative net notional registration thresholds, and not just positions in commodity futures and options.[11]

Constricting diversification strategies for mutual fund offerings, an evitable result of the amendment to Rule 4.5, will directly harm shareholders by reducing opportunities for managing risks against volatility and inflation and preserving liquidity. The CFTC made no mention of, let alone a meaningful effort to quantify, these lost opportunity costs for investors. In fact, before the district court the CFTC suggested it would be "illogical" to alter investment activities to avoid registration, *see* Doc. 15 at 60 n.34, though that precise concern motivated the CFTC's decision to grant the 2003 exclusion, *see* A-611.[12] This failure to recognize these harms to investors is particularly unfortunate, since mutual funds

[11] The allowance in the rule for commodity investments that constitute "bona fide hedging" is too narrow to protect the risk management strategies described. "Bona fide hedging" as defined in now-vacated 17 C.F.R. § 1.3(z) (2012) does not include "[t]he common understanding of 'hedging,' which generally encompasses a broad range of transactions that offset other specific risks, regardless of whether the hedger is a physical market participant or whether the risk hedged is commercial or financial." A-870 (SIFMA Comments at 10). The "bona fide hedging" carved out of Rule 4.5 would not encompass, for example, the sorts of "asset/liability risk management" and "security portfolio risk management" commonly used by fund advisers. *Id.* (citation omitted).

[12] The CFTC also objected that the Directors Forum did not point to comments raising this concern. Commenters did raise this issue. *See*, *e.g.*, A-986; A-1067; A-890.

were not a source of the systemic problems underlying the 2008 financial crisis. *See* A-377 (Dissenting Statement of Commissioner Sommers).

**CONCLUSION**

For the foregoing reasons, *amici curiae* the Mutual Fund Directors Forum and former Commissioners and senior officials of the Securities and Exchange Commission urge the Court to reverse the district court's judgment.

Respectfully submitted,

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**CERTIFICATE OF COMPLIANCE**

Pursuant to Federal Rule of Appellate Procedure 32(a)(7)(C) and D.C. Circuit Rule 32(a), I hereby certify that the foregoing brief complies with the applicable type-volume limitations. This brief was prepared in proportionally spaced typeface using Microsoft Word 2007 in 14-point Times New Roman font. The brief, excluding the parts of the brief exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii) and D.C. Circuit Rule 32(a)(1), contains 6,925 words. This certification is made in reliance on the word-count function of the word processing system used to prepare the brief, Microsoft Word 2007.

*/s/ Steven G. Bradbury*

Steven G. Bradbury

February 6, 2013

## CERTIFICATE OF SERVICE

I certify that on this, the 6th of February, 2013, I caused the foregoing Brief for the Mutual Fund Directors Forum and Former Commissioners and Senior Officials of the Securities and Exchange Commission as *Amici Curiae* in Support of Appellants to be filed with the Clerk of the Court for the United States Court of Appeals for the D.C. Circuit via the CM/ECF system, which will serve counsel listed below.

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