ORAL ARGUMENT SCHEDULED FOR MAY 6, 2013

No. 12-5413

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

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

Appellants,

v.

UNITED STATES COMMODITY FUTURES TRADING COMMISSION,

Appellee.

On Appeal from the United States District Court for the District of Columbia
No. 1:12-CV-00612-BAH (Hon. Beryl A. Howell)

AMENDED BRIEF FOR THE NATIONAL FUTURES ASSOCIATION AND BETTER MARKETS, INC. AS *AMICI CURIAE* IN SUPPORT OF APPELLEE

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March 22, 2013

CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

Pursuant to D.C. Circuit Rules 26.1 and 28(a)(1), the undersigned counsel certifies as follows:

A. Parties and *Amici*

All parties and *amici* appearing before the District Court and in this Court are listed in the Appellants' and Appellee's Briefs. This brief is filed on behalf of *amici* the National Futures Association ("NFA") and Better Markets, Inc. ("Better Markets"), both of whom filed *amicus* briefs in the District Court.

B. Rulings Under Review

The rulings under review are as stated in the Appellants' Brief.

C. Related Cases

The undersigned is not aware of any cases related to this appeal currently pending in any court.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1 and D.C. Circuit Rule 26.1, *amici* NFA and Better Markets state as follows:

1. NFA is a non-profit organization and the independent, self-regulatory organization for the United States futures industry. Its mission is to protect the integrity of the U.S. futures market. It provides innovative regulatory programs and services that ensure futures industry integrity, protect market participants and help its members meet their regulatory responsibilities.

NFA has no parent corporation and there is no publicly held corporation that owns 10% or more of stock in NFA.

2. Better Markets is a non-profit organization founded to promote the public interest in the financial markets. It advocates for greater transparency, accountability, and oversight in the financial system through a variety of activities, including commenting on rules proposed by the financial regulators, public advocacy, litigation, congressional testimony, and independent research.

Better Markets has no parent corporation and there is no publicly held corporation that owns 10% or more of the stock of Better Markets.

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GLOSSARY OF ABBREVIATIONS

APA	Administrative Procedure Act, 5 U.S.C. § 551 *et seq*.
Appellants	Investment Company Institute and Chamber of Commerce of the United States of America
Appellee	U.S. Commodity Futures Trading Commission
Dodd-Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010)
CEA	Commodity Exchange Act
CFTC or the Commission	The U.S. Commodity Futures Trading Commission
CFTC Br.	Brief for U.S. Commodity Futures Trading Commission page citation
CPO	Commodity pool operator
CTA	Commodity trading adviser
ICI Br.	Brief for Investment Company Institute and Chamber of Commerce of the United States of America page citation
ICA	Investment Company Act
MFDF	Mutual Fund Directors Forum
MFDF Br.	Brief for Mutual Fund Directors Forum page citation
NFA	The National Futures Association

RIC	Registered investment company
Rule	Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11,252 (Feb. 24, 2012)
SEC	The Securities and Exchange Commission
SRO	Self-regulatory organization

STATUTES AND REGULATIONS

Appellants' and Appellee's Briefs contain the pertinent statutes.

AMICI CURIAE'S INTEREST, IDENTITY, AND AUTHORITY TO FILE[1]

This brief is submitted by *amici* NFA and Better Markets in support of Appellee.

NFA is the independent SRO for the U.S. futures industry whose mission is protecting the integrity of the U.S. futures market. The CEA, 7 U.S.C. § 21, gave CFTC jurisdiction over commodity futures trading and authorized the futures industry to create an SRO. To fill this role, NFA formed as a membership corporation in 1982 and became a "registered futures association," subject to CFTC oversight. Membership is mandatory for any CPO or CTA that transacts futures business with the public. NFA's members include more than 3,950 firms registered with CFTC and approximately 54,250 individuals who conduct business with the public on U.S. futures exchanges. More than 1,600 members are CPOs.

NFA provides regulatory programs that ensure industry integrity, protect market participants, and help members meet regulatory responsibilities. NFA

[1] No party or party's counsel authored this brief in whole or in part; no party or party's counsel contributed money to fund the preparation or submission of this brief; and no person other than *amici* contributed money to fund the preparation or submission of this brief. FED. R. APP. P. 29(c)(5). *Amici* are filing a joint brief pursuant to the Court's briefing order. Section I reflects NFA's arguments, and Section II reflects Better Markets' arguments. The parties have consented to the filing of this Brief.

establishes and enforces rules for customer protection, which apply to CPOs, CTAs, and others who transact business with the public. Members must comply with ethical standards, including prohibitions against fraud and deceptive practices, and with procedures for supervising employees and handling discretionary accounts.

NFA submits this brief to advise the Court of the vital public interest served by the Rule, and explain the harm to retail investors if it were invalidated. NFA brings a unique perspective because of its regulatory role and its authorship of the rulemaking petition that led to the Rule. NFA emphasizes the importance of providing the investing public with broad access to the derivatives markets. Regulatory oversight, however, is essential to protect the public.

Better Markets is a non-profit organization that promotes the public interest in the financial markets. One way it furthers its mission is by defending rules promulgated by financial regulators against interested parties seeking to overwhelm those agencies with a burdensome and unwarranted economic analysis obligation, typically labeled "cost-benefit analysis," that has no legal basis.

Here, Appellants claim that CFTC failed to conduct an adequate "cost-benefit analysis" when it promulgated the Rule. A decision invalidating the Rule on this ground would (1) eliminate the Rule's investor protection and market oversight tools; (2) perpetuate and promote the erroneous view that, under CEA

Section 15(a), 7 U.S.C. § 19(a), Congress intended to burden CFTC with the costly, time-consuming, and ultimately counter-productive duty to conduct cost-benefit analysis for each of its rules; and (3) undermine the agency's ability to finalize a host of essential reforms under Dodd-Frank and to defend its already-implemented rules in court.

BACKGROUND

I. NFA'S AND CFTC'S REGULATION OF COMMODITY POOLS THAT ARE RICS

By requiring registration of RICs that cannot qualify for the Rule's exclusion from the CPO definition, CFTC provides substantial benefit to retail investors by subjecting affected RICs to oversight by the agency with expertise in commodity derivatives. CFTC registration also subjects these RICs to NFA's membership requirement. Without CFTC registration and NFA membership, neither CFTC nor NFA has oversight over RICs engaging in derivatives transactions, regardless of the volume of activity, thereby putting investors at risk.

CFTC and NFA have a decades-old relationship and routinely share information about registered entities. NFA performs background checks on derivatives professionals, publicly displays registration and disciplinary information, and administers competency tests for derivatives professionals. Through the National Commodity Futures Examination, NFA tests knowledge of the derivatives markets, rules, and regulations, areas not covered by FINRA's

examinations of securities professionals. NFA also maintains important regulatory information about CPO Members, including information about types of and concentration of investments. This information allows NFA to monitor risks associated with registered CPOs and intervene quickly when potential violations of NFA rules or other risks may affect markets or customers.

NFA Members are required to comply with NFA and CFTC rules. NFA conducts periodic on-site regulatory examinations to ensure that Members maintain accurate records and protect customers against unscrupulous activities. NFA examines Member CPOs' sales practices, accounting procedures, financial records, risk management practices, internal controls, and performance and fees. NFA's and CFTC's oversight in these areas provide critical protections to commodity pool investors, which investors in RICs engaged in significant derivatives trading should receive.

II. CFTC'S PAST EXCLUSION OF CERTAIN RICS FROM REGULATION

In 1985, CFTC adopted Rule 4.5, which originally excluded from CPO registration RICs that used derivatives for hedging only where: (1) the RIC's commodity interest transactions were all bona fide hedges or other anticipatory hedges; (2) the RIC did not use more than 5% of its assets as initial margin in derivatives trading ("*de minimis* trading restriction"); and (3) the RIC was not marketed as a commodity pool or other vehicle for trading in commodity interests

("no-marketing restriction"). 50 Fed. Reg. 15,868 (Apr. 23, 1985). This regulatory framework remained until 1993, when CFTC amended Rule 4.5 to broaden the *de minimis* trading restriction by removing the condition that the derivatives trading be limited to hedging. Following that amendment, a RIC could engage in an unlimited amount of bona fide hedging activity, and other speculative strategies, and still qualify for the exclusion, provided no more than 5% of its assets were used as initial margin. 58 Fed. Reg. 6,371 (Jan. 28, 1993). Both this broader *de minimis* trading restriction and the no-marketing restriction were eliminated in 2003 during the financial deregulation movement. 68 Fed. Reg. 47,221, 47,223 (Aug. 8, 2003).

CFTC's decision to eliminate these restrictions in 2003 – excluding essentially all RICs from the CPO definition – resulted from a very different financial regulatory environment than exists today. CFTC explained that eliminating this oversight was appropriate given the "investment environment" at the time and would "have no effect . . . on the financial integrity . . . of the commodity futures and options markets." *Id.* at 47,223, 47,230. CFTC also explained that, since investment companies are "'otherwise regulated,' the Commission believes that . . . these persons and entities may not need to be subject to any commodity interest trading criteria to qualify for relief under Rule 4.5." 68 Fed. Reg. 12,622, 12,625-12,626 (Mar. 17, 2003).

III. REGULATORY RESPONSES TO THE FINANCIAL CRISIS

The unprecedented crisis in the financial markets in 2007-08 ushered in a new regulatory era. With the painful lessons of that crisis, Congress became deeply concerned about systemic market risks posed by unregulated investments in derivatives. In 2010, Congress passed Dodd-Frank, which provided a definition of commodity pool and expressly extended CFTC's jurisdiction over "swaps." Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 7 U.S.C. §§ 1a(1) & 1a(11)).

A month after Dodd-Frank's enactment, NFA filed a rulemaking petition requesting that CFTC (1) reinstate Rule 4.5's *de minimis* trading and no-marketing restrictions, and (2) make investment companies that cannot meet these requirements ineligible for Rule 4.5's exclusion.[2] *See* 75 Fed. Reg. 56,997 (Sept. 17, 2010) (CFTC's Notice of the petition). As NFA described, instead of directly and openly investing in commodity futures, several RICs have been using wholly-owned and controlled subsidiaries to make those investments on their behalf. NFA Pet. 3-4, 6-9. While the offering materials for these RICs indicate that the subsidiaries are subject to investment restrictions applicable to the RICs, in reality, the subsidiaries' derivatives trading activities are not regulated by anyone. *See id.* Certain RICs took full advantage of the 2003 amendments to Rule 4.5 and began to

[2] The NFA petition is part of the administrative record filed with the District Court. AR 199-210 (Dist. Ct. Dkt. No. 30-3 at 2-13).

use derivatives extensively in their investment strategies, sometimes directly marketing units in these investment companies to retail investors as commodity investments with minimum investments as low as $2,500.[3] These RICs are *de facto* commodity pools that fall entirely outside CFTC's and NFA's customer protection regulatory regime. *See id.* This lack of regulatory oversight is completely at odds with the intent of Dodd-Frank, the regulatory environment triggered by the 2007-08 financial crisis, and CFTC-SEC jurisdictional boundaries that clearly delineate who has regulatory oversight over derivatives transactions.

NFA argued that one of the key premises for the 2003 amendments – that investment companies were "otherwise regulated" regarding their derivatives trading – is no longer true. *Id.* at 10. Based on this fact, NFA urged CFTC to amend Rule 4.5 to restore the pre-2003 *de minimis* trading and no-marketing operating restrictions. *Id.* at 11. Indeed, only by rescinding the 2003 amendments could CFTC – and NFA – exercise oversight over RICs that engage in more than a *de minimis* amount of derivatives trading or market units to the public as vehicles for investing in derivatives. As NFA emphasized, CFTC and NFA are the only regulatory bodies that have the experience, expertise, and jurisdiction to

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

comprehensively and meaningfully regulate managed retail futures products. *Id*. at 10.

In February 2011, CFTC issued a Notice of Proposed Rulemaking that cited NFA's petition and proposed to amend Rule 4.5 to rescind or narrow several exemptions and exclusions, including the CPO exclusion for RICs. 76 Fed. Reg. 7,976, 7,983-7,984 (Feb. 11, 2011). CFTC noted that the proposed changes were designed to "bring the Commission's CPO . . . regulatory structure into alignment with the stated purposes of [] Dodd-Frank." *Id*. at 7,978. The CPO definition, as revised by Dodd-Frank, includes a subsection that permits CFTC to exclude persons or entities from the definition if CFTC determines that the exclusion will "effectuate the purposes of this [Act]." 7 U.S.C. §§ 1a(10)(B) and 1a(11)(B).

On February 24, 2012, CFTC amended Rule 4.5 to re-impose the *de minimis* trading and no-marketing restrictions upon RICs seeking to avail themselves of the CPO exclusion. 77 Fed. Reg. 11,252 (Feb. 24, 2012). Although the restrictions were similar to those rescinded in 2003, CFTC made modifications based on industry comments, including adopting an alternative *de minimis* trading restriction, providing that an investment company's aggregate notional value of

commodity futures, commodity options, and swaps cannot exceed 100% of an investment company's net liquidating value. *See* Rule 4.5(c)(2)(iii)(B).[4]

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

The Rule also recognizes CFTC's willingness to contain costs by harmonizing regulations with SEC. CFTC utilized a similar harmonization process in 2011, when it adopted amendments to rules applicable to certain commodity exchange traded funds. *See* 76 Fed. Reg. 28,641 (May 18, 2011). Finally, as part of its compliance with Section 15(a), CFTC considered costs that RICs will incur if required to register as CPOs. These costs include those associated with CFTC

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[4] Additionally, in response to comments, CFTC provided seven instructive factors to explain the plain language of the no-marketing restriction. 77 Fed. Reg. 11,252, 11,258-11,259 (Feb. 24, 2012).

registration process and NFA membership. Most are *de minimis*, including initial registration fees of $85 and $200, annual membership dues of $750, and other miscellaneous compliance costs. *See* NFA Rule 203; NFA Bylaw 1301.[5]

After CFTC announced its proposed rulemaking in 2011, SEC separately issued a Concept Release, requesting comments "on a wide range of issues . . . including the potential implications for fund leverage, diversification, exposure to certain securities-related issuers, portfolio concentration, valuation, and related matters," to aid in its review of RICs' use of derivatives. SEC Concept Release, *Use of Derivatives by Investment Companies Under the Investment Company Act of 1940*, 76 Fed. Reg. 55,237 (Sept. 7, 2011) ("Concept Release").[6] The Concept Release explained that "[t]he dramatic growth in the volume and complexity of derivatives investments over the past two decades, and funds' increased use of derivatives, have led the [SEC] . . . to initiate a review of funds' use of derivatives under the [ICA]." 76 Fed. Reg. at 55,238. SEC noted that "derivatives can raise risk management issues for a fund relating, for example, to leverage, illiquidity . . . , and counterparty risk, among others," and that the purpose of its review "is to

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[5] NFA's rules and bylaws are in NFA's Manual, available on NFA's website at http://www.nfa.futures.org/nfamanual/NFAManual.aspx.

[6] SEC uses the phrases "investment company," "fund," and "mutual fund" interchangeably to refer to a specific type of RIC, the open-end management company. Investment companies are subject to the ICA's regulatory framework, a core purpose of which is to protect investors from the potentially adverse effects of leverage. *See* 15 U.S.C. § 80a-1(b)(7).

evaluate whether the regulatory framework, as it applies to funds' use of derivatives, continues to fulfill the purposes and policies underlying the Act and is consistent with investor protection." *Id.* It explained further that it "intends to consider the comments to help determine whether regulatory initiatives or guidance are needed to improve the current regulatory regime for funds." *Id.* at 55,237.

The ICA applies only to RICs, while investment advisors and their selling broker-dealers are subject to different statutes. FINRA is an SRO with jurisdiction over registered representatives of broker-dealers and their employers. Importantly, CPOs are not members of FINRA. By contrast, NFA has jurisdiction over CPOs and their derivatives trading activity.

SUMMARY OF ARGUMENT

Among the lessons learned from the recent turmoil in the financial markets and global economic crisis is the importance of regulatory oversight for the benefit of the investing public. There is a compelling interest in the regulation of RICs' use of derivatives which, because they rely on leverage, are highly risky. CFTC unquestionably has the authority to regulate in this area, and the Rule will restore CFTC oversight to again include RICs that use derivatives beyond a *de minimis* amount and/or that market units for trading in commodity interests. The Rule targets a broad array of transactions not covered by the ICA that are not regulated

by SEC or CFTC. The Rule is supported by a compelling public interest and easily satisfies the deferential arbitrary and capricious standard for agency rulemaking.

CFTC further fulfilled its duty to consider the Rule's costs and benefits. First, Section 15(a) of the CEA imposes a limited obligation on CFTC to **consider** its rules' costs and benefits in light of five specific **public interest** factors. Under the statutory language and the relevant case law, CFTC has broad discretion in discharging this duty. It has no obligation to quantify costs or benefits, weigh them against each other, or find that a rule will confer a net benefit.

Second, in considering the costs and benefits of rules implementing financial reform after the 2008 financial crisis, CFTC must give proper weight to the overriding objective of preventing another financial collapse and economic crisis. Against the backdrop of the worst financial and economic crisis since the Great Depression, it is inconceivable that implementation of those reforms should hinge on rule-by-rule cost-benefit analyses that subordinate the purpose of the new regulatory framework and give controlling weight to cost concerns from the very industry responsible for the crisis.

Finally, CFTC fulfilled its Section 15(a) duty by considering the Rule's costs and benefits and placing utmost importance on the ultimate benefit of avoiding another financial crisis.

ARGUMENT

I. THE RULE CLOSES A REGULATORY GAP AND INCREASES OVERSIGHT OF THE DERIVATIVES MARKETS

A. The Rule provides critical protections for investors beyond those in the ICA.

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

To the extent the ICA provides any authority to regulate RICs' use of derivatives, the record before CFTC demonstrated that the present regulatory framework is inadequate. NFA's petition provided specific examples of investment companies soliciting investments from retail customers for use in the derivatives market and instances where the ICA's investor protection regime did not offer adequate regulatory protection. Investment companies' use of wholly-owned subsidiaries that are not directly regulated by any U.S. financial regulator to trade derivatives escalated NFA's concerns. NFA Pet. 8-9.

CFTC cited NFA's petition in explaining the Proposed Rulemaking:

> In 2010, the Commission became aware of certain [RICs] that were offering series of de facto commodity pool interests claiming exclusion under § 4.5. The Commission consulted with market participants and NFA regarding this practice. Following this

> consultation, NFA submitted a petition for rulemaking in which NFA suggested certain revisions to § 4.5 with respect to [RICs].

76 Fed. Reg. at 7,983. CFTC incorporated this information into its final rulemaking release. 77 Fed. Reg. at 11,254.

There is no merit to Appellants' suggestion that the Rule is duplicative of existing regulations. That much should be clear from the examples cited in the NFA Petition, which formed part of the basis for CFTC's decision to re-impose the *de minimis* and no-marketing restrictions. Moreover, the SEC Concept Release is replete with questions regarding the scope and applicability of the present regulatory framework to derivatives, undermining the claim that existing regulations administered by SEC already address these transactions.

While the ICA does not explicitly regulate derivatives, SEC has interpreted Section 18(f) as reaching certain types of derivatives. That Section generally prohibits an open-end management company from issuing a "senior security," defined as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends." 15 U.S.C. § 80a-18(f). Because leverage is the signature characteristic of a derivative, SEC reasons that the definition of "senior security" should include derivatives that function like evidences of indebtedness, where payment of principal or interest stands in front of any dividends or other payments to owners

of common shares, i.e., "externally" leveraged derivatives. *See* ICA Release No. 10666, 44 Fed. Reg. 25,128 (Apr. 27, 1979) ("Release 10666"); Guidelines for Preparation of Form N-8B-1, ICA Release No. 7221 (June 9, 1972), 37 Fed. Reg. 12,790 (June 29, 1972).

Under this interpretation, SEC could have prohibited RICs from trading in derivatives that meet the "senior security" definition, unless they complied with all the restrictions in Section 18(f). Instead, through Release 10666, it provided that investment companies that invest in "senior security"-type derivatives may "cover" such transactions by (1) setting aside, in a segregated account, assets equal in value to 100% of the investment company's obligation; or (2) engaging in other transactions that offset the investment company's exposure. Compliance with one of these requirements relieves a RIC from any obligation to comply with Section 18(f)'s restrictions.

Release 10666 provides no guidance when a RIC is engaging in derivatives transactions that cannot be characterized as a "senior security." Release No. 10666 is silent on derivatives that are "internally" leveraged, i.e., where the effect of leverage is embedded within the instrument itself. Thus, the Rule does *not* regulate transactions already addressed by SEC.

Indeed, the ICA is ill-suited to address certain issues that are inherent to derivatives transactions. For instance, Section 12(d)(3) prohibits an investment

company from investing in any security issued by the business of a broker-dealer, underwriter, or registered investment adviser. 15 U.S.C. § 80a-12(d)(3). This section reflects Congress's intent to prohibit investment companies from investing in securities-related businesses to prevent conflicts of interest and inappropriate reciprocal practices. Concept Release 57. In short, SEC's own interpretation of the Act demonstrates that the ICA is not a comprehensive framework for the regulation of derivatives by investment companies.

Finally, by giving CFTC and SEC concurrent jurisdiction over certain types of derivatives, Congress has evidenced its intent that derivatives traders may be subject to regulation by both agencies. Congress **could** create an exception in the CEA's definition of "CPO" for persons registered with SEC, **but it never has**. In fact, Congress has rejected SEC's attempts to eliminate the CFTC's jurisdiction in areas of overlap. *See Bd. of Trade v. SEC*, 677 F.2d 1137 (7th Cir. 1982), *vacated as moot*, 459 U.S. 1026 (1982). Congress has left to CFTC's discretion the question of who is subject to CFTC regulation as a CPO, empowering CFTC to permit exclusions when doing so would further the CEA's purposes. 7 U.S.C. §§ 1a(11)(A), 5(b). If entities properly regulated by CFTC and SEC find complying with the regulations promulgated by both unduly burdensome, they may seek a legislative remedy. It is not, however, "arbitrary or capricious" for CFTC to

exercise the regulatory authority Congress has given it to oversee derivatives transactions engaged in by RICs.

B. <u>The Rule provides critical protection to investors at minimal cost to affected RICs.</u>

Without CFTC registration, neither CFTC nor NFA will have any oversight over RICs engaging in derivatives transactions, regardless of the extent of that activity, thereby putting investors at risk. With the Rule, affected RICs will be subject to CFTC oversight, and NFA will have the ability to examine these RICs for compliance with the CEA. This will help protect retail investors.

The assertion of *amici* MFDF and former SEC officials that RICs will incur substantial costs if required to become NFA members is simply overblown. In particular, if a RIC is presently investing more than a *de minimis* amount in derivatives, its board of directors – in the exercise of its fiduciary duty – may well have already ensured that the RIC's investment advisor has compliance personnel who are qualified in derivatives transactions and regulations. And, as described above, other costs associated with NFA-membership are minimal.

Finally, CFTC is taking affirmative steps to address Appellants' concerns about duplicative regulatory requirements. CFTC has proposed harmonizing its CPO requirements for RICs with the rules under the ICA in the areas of recordkeeping, disclosure, and reporting. 77 Fed. Reg. 11,345 (Feb. 24, 2012). Complaints about duplicative regulation are premature and fail to recognize

CFTC's prior success in a similar harmonization process applicable to CPOs in the context of CFTC-SEC dually regulated commodity pool exchange-traded funds. *See* 76 Fed. Reg. 28,641 (May 18, 2011).

II. CFTC HAS A LIMITED DUTY TO CONSIDER THE COSTS AND BENEFITS OF ITS RULES, NOT TO CONDUCT COST-BENEFIT ANALYSIS, AND IT COMPLIED WITH ITS DUTY

A. Section 15(a) requires CFTC to consider the costs and benefits of its rules in light of the public interest, not to conduct cost-benefit analysis.

1. The obligation to "consider" certain factors is a statutorily-limited duty conferring broad discretion on CFTC.

CEA Section 15(a) directs CFTC to "consider the costs and benefits of [its] action," and "evaluate" those considerations in light of five enumerated "considerations." 7 U.S.C. § 19(a). This wording and the relevant case law make clear that Congress intended CFTC to exercise broad discretion in fulfilling this obligation. The Supreme Court has long recognized that when statutorily-mandated considerations are not "mechanical or self-defining standards," they "imply wide areas of judgment and therefore of discretion." *Sec'y of Agric. v. Cent. Roig Ref. Co.*, 338 U.S. 604, 611-12 (1950).

According to this Court, where "Congress did not assign the specific weight the [agency] should accord each of these factors, [it] is free to exercise [its] discretion in this area." *N.Y. v. Reilly*, 969 F.2d 1147, 1150 (D.C. Cir. 1992); *see also Brady v. FERC*, 416 F.3d 1, 6 (D.C. Cir. 2005). Indeed, when an agency must

"consider" certain factors during rulemaking, a reviewing court's role is limited. Courts are not to find a rule arbitrary and capricious under the APA, 5 U.S.C. § 706(2)(A), unless the agency "wholly failed" to consider an enumerated factor. *Pub. Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209, 1216 (D.C. Cir. 2004).[7]

Appellants attach undue significance to the word "evaluate" in Section 15(a). Resorting to the dictionary, they argue that "evaluate" imposes a "stringent" duty to "determine or fix the value of or to determine the significance, worth, or condition of a thing." ICI Br. 38 n.7. However, "evaluate," as commonly understood and as defined in that dictionary, does not necessitate cost-benefit analysis. Regardless, Appellants' claimed interpretation is trumped by the statute's structure, its repeated reliance on the judicially interpreted term "consider," and the listed factors. The core obligation is a duty to "consider the costs and benefits." Each factor is a "consideration." And, all five considerations concern the public interest, resist quantitative analysis, and omit reference to any industry-focused cost concerns. Thus, one use of "evaluate" as a synonym to create more readable legislative text cannot be used to defeat Congress's deliberate and repeated reliance on the judicially interpreted concept of "consider."

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[7] *Public Citizen*, 374 F.3d at 1221, suggested that the agency had to "weigh" costs and benefits even though the statute simply required the agency to "consider" them. However, that suggestion was pure dicta, and it arose from prescriptive language in a separate provision of the applicable statute. *Id.* at 1216.

2. The five factors in Section 15(a) demonstrate Congress's primary concern that regulations protect the public, not limit the inevitable costs of regulation to industry.

All five factors in Section 15(a) relate to a public benefit arising from a robustly regulated marketplace, including preventing abuse, promoting competition, enhancing transparency, and limiting systemic risk.[8] None mentions any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements. *Compare* 42 U.S.C. § 300g-1(b)(3)(C); 42 U.S.C. § 6295(d) (1976 ed., Supp. II).

Removing any doubt, the fifth factor references "any other public interest considerations." 7 U.S.C. § 19(a)(2)(E). Under principles of statutory construction, each prior factor derives its meaning from this factor, the public interest. *See Neal v. Clark*, 95 U.S. 704, 708-09 (1877). Thus, CFTC correctly recognized the dispositive role of the public interest under Section 15(a). Proposed Rule, 76 Fed. Reg. at 7,988.

3. Section 15(a) contains no language requiring cost-benefit analysis.

CFTC's statutory obligation is also determined by the **absence** of language Congress uses when it intends an agency conduct cost-benefit analysis. The Supreme Court has declared that a cost-benefit analysis duty is not to be inferred

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[8] Section 15(a) also closely parallels the public interest objectives of the CEA. 7 U.S.C. § 5(a)-(b).

lightly or without a clear indication from Congress. *Am. Textile Mftrs. Inst., Inc., v. Donovan*, 452 U.S. 490, 510-512 & n.30 (1981); *see also Whitman v. Am. Trucking Ass'ns, Inc.*, 531 U.S. 457, 471 (2001). When Congress intends cost-benefit analysis to apply, it explicitly refers to "costs" and "benefits" and specifies the nature of the analysis, requiring a specific weighing and often quantification.

For example, unlike Section 15(a), statutes that mandate a **balancing** of costs and benefits explicitly include language of comparison. *See Am. Textile Mftrs.*, 452 U.S. at 511-12, n.30 and statutes cited therein. Accordingly, courts refuse to require a specific balancing of costs and benefits when not plainly mandated by statute. The Court in *Weyerhaeuser Co. v. Costle*, 590 F.2d 1011, 1045 (D.C. Cir. 1978), found that statutory language requiring the agency to "take into account" costs and other "appropriate" factors does **not** require the agency "to use any specific structure such as a balancing test in assessing the . . . factors" nor "to give each . . . factor any specific weight." *See also Nat'l Ass'n of Home Builders v. EPA*, 682 F.3d 1032, 1039 (D.C. Cir. 2012) (statutes requiring agencies to "consider" the "economic" impact or "costs" do not require cost-benefit analysis); *Cent. Ariz. Water Conservation Dist. v. EPA*, 990 F.2d 1531, 1542 n.10 (9th Cir. 1993) (statute requiring "consideration" does not require cost-benefit analysis).

Similarly, statutes requiring **quantification** of costs and benefits, unlike Section 15(a), are explicit. *See, e.g.*, 42 U.S.C. § 300g-1(b)(3). Accordingly, courts have held that quantification is not required when not statutorily mandated. *See FMC Corp. v. Train*, 539 F.2d 973, 978-79 (4th Cir. 1976) (quantification of benefits in monetary terms not required); *cf. Am. Fin. Services Ass'n. v. FTC*, 767 F.2d 957, 986 (D.C. Cir. 1985) (even cost-benefit analysis need not be "based on a rigorous, quantitative economic analysis").

Clearly, CFTC is not required to balance or quantify its rules' costs and benefits.[9]

4. Appellants' reliance on three cases involving SEC's duty is mistaken.

Appellants and *amicus* MFDF rely heavily on three cases from this Court that address **SEC's** duty to assess the economic consequences of its rules. *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011); *Am. Equity Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010); *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005). They contend that under those decisions, CFTC must quantify the Rule's costs and benefits, evaluate them in relation to a baseline, and make a net benefit finding. ICI Br. 47-48; MFDF Br. 13-15.

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[9] Legislative proposals seeking to impose a cost-benefit analysis obligation on CFTC, *see, e.g.*, H.R. 1840, 112th Cong. (introduced May 11, 2011), also support a finding that the CEA does not already mandate cost-benefit analysis. *See Am. Textile Mfrs.*, 452 U.S. at 512 n.30.

This contention is misplaced. First, those cases are distinguishable because the statutes at issue differ, particularly the enumerated considerations. For example, Section 15(a) explicitly refers to "other public interest considerations," a powerful indication that Congress intended above all to protect the public.

Second, those panels never expressly held that SEC had a duty to conduct "cost-benefit analysis." And, to the extent those decisions could be read as requiring such a duty, or any duty more onerous than what Congress actually imposed, that interpretation would not be entitled to precedential weight. "Questions which merely lurk in the record, neither brought to the attention of the court nor ruled upon, are not to be considered as having been so decided as to constitute precedents." *Webster v. Fall*, 266 U.S. 507, 511 (1925); *Honeywell Int'l, Inc. v. EPA*, 374 F.3d 1363, 1374 (D.C. Cir. 2004).

In **none of those cases** did the parties argue or the panels address the judicial precedents that interpret "consider" as imposing a limited duty, that require explicit statutory language before finding that cost-benefit analysis applies, and that recognize cost-benefit analysis can impede the achievement of regulatory objectives.

Finally, to the extent those cases require compliance with principles of cost-benefit analysis found in Executive Orders, such as conducting a baseline analysis,

they would be wrong. *See* ICI Br. 2.[10] CFTC and all independent regulatory agencies are expressly **excluded** from those provisions. Executive Order 13,579, 76 Fed. Reg. 41,587 (July 14, 2011); Executive Order 13,563, 76 Fed. Reg. 3,821, § 7 (Jan. 21, 2011); Executive Order 12,866, 58 Fed. Reg. 51,735, § 3(b) (Oct. 4, 1993).

Executive Order 13,579 addresses the independent agencies, but it does not obligate them to conduct cost-benefit analysis. It uses entirely advisory language. And, although it encourages agencies to follow a list of guidelines in prior orders, and to conduct retrospective rule review, it carefully excludes from that list any reference to the specific sections on cost-benefit analysis. *Id.* at § 1(c).[11]

B. <u>When considering the costs and benefits of rules implementing financial reform after the 2007-08 crisis, CFTC must consider the overriding goal of preventing another crisis.</u>

CFTC's obligation to consider the goal of preventing future financial crises derives from Section 15(a) and Dodd-Frank. Section 15(a) requires CFTC to

[10] Even if CFTC had to assess some baseline, it clearly did so as recognized by the lower court. A-67-70.

[11] Nor is there any other law subjecting CFTC to a cost-benefit duty. Contrary to Appellants' suggestion, ICI Br. 47, the APA does not require such an analysis. *Vill. of Barrington v. Surface Transp. Bd.*, 636 F.3d 650, 670-71 (D.C. Cir. 2011). Indeed, requiring CFTC to conduct cost-benefit analysis would conflict with the rationale for the Supreme Court's prohibition against imposing procedural requirements on agencies beyond the APA. *Vt. Yankee Nuclear Power Corp. v. NRDC*, 435 U.S. 519, 543 (1978). The Court's respect for agency expertise, *id.* at 524-25, applies with even greater force to an agency's economic analysis. *See AFL-CIO v. Marshall*, 617 F.2d 636, 665 n.167 (D.C. Cir. 1979).

consider "any other public interest considerations." This imposes a contextual obligation to consider whatever public interest goals a rule serves under the prevailing conditions.

The present-day conditions are obvious: In the aftermath of the worst crisis since the Stock Market Crash of 1929, which triggered the worst economic downturn since the Great Depression, the most compelling public interest is preventing another crisis. The Rule serves this purpose, and its costs and benefits must therefore be considered in this context.

A second rationale for this holistic approach springs from Dodd-Frank itself. The overriding objective of a law confers broad discretion on an agency as it considers the costs and benefits of a rule necessitated by that law. *See FMC Corp.*, 539 F.2d at 978-79; *see also Fla. Manufactured Hous. Ass'n v. Cisneros,* 53 F.3d 1565, 1578 (11th Cir. 1995).

Here, the law necessitating the Rule is Dodd-Frank, and its objective is "[t]o promote the financial stability of the United States" to prevent another financial crisis. Dodd-Frank, Preamble. Congress's intent was unmistakable from the breadth and depth of the law: Fundamentally change the regulatory structure so our financial markets can never again generate the levels of risk, recklessness, and abusive conduct that triggered the financial crisis. *See* S. REP. No. 111-176, at 2

(2010); *see also* Senator Dodd, 156 Cong. Rec. S 2688 (daily ed. Apr. 27, 2010); Senators Dorgan & Levin, 156 Cong. Rec. S 5931 (daily ed. July 15, 2010).

The Rule is clearly necessary and appropriate under Dodd-Frank, even though not expressly required. Dodd-Frank gave CFTC regulatory authority over an entirely new swaps regime; expanded the definition of CPO to encompass swap transactions; imposed reporting requirements on private fund advisers, which present the same "sources of risk" posed by CPOs; and appointed CFTC as a member of the Financial Stability Oversight Council, tasked with gathering data, monitoring financial markets, and addressing systemic risk. 77 Fed. Reg. at 11,252-53. Thus, as recognized by the lower court, the Rule is necessitated by and grounded in Dodd-Frank. A-26-29. Its benefits must therefore be considered in terms of the benefit of the overriding objective of the entire collection of Dodd-Frank reforms.

The benefit of avoiding another financial crisis is enormous. By conservative estimates, the ongoing crisis will cost **at least $12.8 trillion**. BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012).[12] And the Government Accountability Office has found that "the present value of cumulative output losses [from the crisis] could exceed $13 trillion." GAO,

[12] *Available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf.

FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, GAO-13-180, 17 (Jan. 2013). These estimates evidence the cost of any future financial crisis and reveal the importance and benefits of regulatory reform – including the Rule. CFTC was obligated to consider this overarching goal when promulgating the Rule, and this perspective must inform the Court's review.

C. CFTC complied with Section 15(a) as correctly interpreted.

1. CFTC considered costs and benefits.

CFTC catalogued all the compliance costs of registration and data collection and their attendant variables. 77 Fed. Reg. at 11,272-275, 11,277, 11,281; A-74-75. It also sought to mitigate those costs for dually registered entities while protecting market participants and the public. 77 Fed. Reg. at 11,281. As found by the district court, "CFTC is not required to promulgate only rules that have low or no costs; rather the agency is simply required to show that they "*considered*" and "*evaluated*" the costs of the rule." A-83 (original emphasis). The agency did this.

Moreover, as detailed by the lower court, CFTC described the Rule's benefits, which include important investor protections and enhanced regulatory tools to improve CFTC oversight. A-55-57. Registration will help CFTC ensure competency and fitness and will provide it "and members of the public with a clear

means of addressing the wrongful conduct by [registered] individuals and entities." 77 Fed. Reg. at 11,254, 11,277.

Similarly, data collection "increases the amount and quality of information available regarding a previously opaque area of investment activity and, thereby, enhances the ability of the Commission to protect investors and oversee derivatives markets." *Id.* at 11,281. With this previously unavailable data CFTC "will be able to tailor its regulations to the needs of, and risks posed by, entities in the market, and to protect investors and the general public from overly risky behavior." *Id.*

The Release highlights the importance of these benefits by describing the threat investment company CPOs, particularly mutual funds, pose to investors and the financial system. The record shows that "a relatively small investment in a derivative instrument can expose a [mutual] fund to potentially substantial gain or loss." *Id.* at 11,255.

NFA's petition for rulemaking, cited in the Release, *id.* at 11,254 n.27, indicates that there are "at least three entities filing for exclusions under Regulation 4.5 with respect to [RICs] that they operate;" that they have the same goal as public commodity pools; that they market themselves to customers as commodity futures investments; and that they indirectly invest substantially in derivatives and futures to achieve a managed futures exposure equal to the full net value of the fund. A-1433. Additionally, "[s]ince Rule 4.5 is an exclusion rather than an

exemption, the anti-fraud provisions of Section 4(o) do not apply," thus depriving investors of important legal protections. A-1434; *see also* Letter from Senators Carl Levin & Tom Coburn to IRS, 3 (Dec. 20, 2011) (estimating 72 mutual funds similarly circumvent federal regulation).

More troubling is the fact that "[i]nvestments in these vehicles can be – and often are – sold to unsophisticated customers." A-1433. Approximately 52.3 million U.S. households (or 44%) own shares in mutual funds, mainly for retirement. ICI, *2012 Investment Company Fact Book: A Review of Trends in the U.S. Investment Company Industry,* 87 (2012). Without the Rule, these investors are at heightened risk of exploitation by up to 8,684 mutual funds that are increasingly inclined to engage in this activity without sufficient oversight. *Id.* at 18; 77 Fed. Reg. at 11,255; *see also CFTC v. British Am. Commodity Options Corp.*, 560 F.2d 135, 139-140 (2d Cir. 1977) (Registration gives CFTC "the information . . . which it so vitally requires to carry out its other statutory functions. . ..").

In sum, CFTC adequately considered the Rule's costs and benefits under Section 15(a).[13]

[13] CFTC actually exceeded its duty by quantifying costs and benefits where "reasonably practicable to do so." 77 Fed. Reg. at 11,276; *cf. BASF Wyandotte Corp. v. Costle*, 598 F.2d 637, 657 (1st Cir. 1979) ("[G]iven the reticence of the industry to supply information, [the agency] needed to develop no more than a rough idea of the costs the industry would incur.").

2. CFTC considered the benefits of preventing another crisis.

In accordance with Section 15(a), Dodd-Frank, and the relevant case law, CFTC considered the overriding objective of preventing another financial crisis.

CFTC was fully cognizant of the crisis, Congress's resolve to prevent its recurrence through Dodd-Frank, and CFTC's own duty to promulgate regulations that fulfill the letter and spirit of the law. The rulemaking record confirms this point. CFTC observed that "Congress enacted Dodd-Frank in response to the financial crisis," and found that the Rule would supplement Dodd-Frank, thus helping to prevent a future crisis. 77 Fed. Reg. at 11,253; *see also* Commissioner Scott O'Malia, Statement of Concurrence, CPOs and CTAs: Amendments to Compliance Obligations, Feb. 2, 2012 ("The financial crisis . . . highlights the need for more accessible and effective consumer protection measures.").

Regarding the specific Rule provisions, CFTC stated that "[t]he sources of risk delineated in [Dodd-Frank] with respect to private funds are also presented by commodity pools," and registration and data collection will help the agency comply with the spirit and letter of Dodd-Frank's provisions on financial stability. 77 Fed. Reg. 11,252-53. Consequently, according to CFTC, data collection will yield "risk mitigation as it pertains to the overall financial stability of the United States," which although not quantifiable, "is 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; *see also* 76 Fed. Reg. at 7,980 (The forms reflect "the purpose and requirements of the Dodd-Frank Act."). Similarly, the inclusion of swaps in the Rule will help ensure that CFTC can effectively oversee swaps trading, a previously opaque investment activity. 77 Fed. Reg. at 11,252, 11,256, 11,258.

"Following the recent economic turmoil, and consistent with the tenor of the provisions of the Dodd-Frank Act," CFTC appropriately reconsidered the level of CPO regulation and adopted the Rule. *Id*. at 11,253. The lower court validated this approach, stating that no "more exacting benefit calculation needs to be made in this case, particularly here, where the agency is fulfilling expanded regulatory responsibilities mandated under Dodd-Frank."

CONCLUSION

For the foregoing reasons, the Court should affirm the lower court's ruling and uphold the Rule.

March 22, 2013

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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 in 14-point Times New Roman font. The brief, excluding the parts exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii) and D.C. Circuit Rule 32(a)(1), contains 6,947 words. This certification is made in reliance on the word-count function of the word processing system used to prepare the brief.

/s/ John M. Devaney
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March 22, 2013

CERTIFICATE OF SERVICE

I certify that on March 22, 2013, I caused the foregoing Brief for the National Futures Association and Better Markets, Inc. as *Amici* Curiae in Support of Appellee 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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