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

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GLOSSARY

APA	Administrative Procedure Act
CEA	Commodity Exchange Act
CFMA	Commodity Futures Modernization Act of 2000
CFTC or the Commission	Commodity Futures Trading Commission
CPO	Commodity Pool Operator
FINRA	Financial Industry Regulatory Authority
IAA	Investment Advisers Act of 1940
ICA	Investment Company Act of 1940
ICI	Investment Company Institute
NFA	National Futures Association
PRA	Paperwork Reduction Act
SEC	Securities and Exchange Commission
The Chamber	Chamber of Commerce of the United States of America

SUMMARY OF THE ARGUMENT

In this rulemaking, the CFTC made two essential mistakes: It failed to address important matters that it should have considered, and took credit for things it could not. Either of those errors is sufficient to vacate an agency's rule, particularly when the agency has a statutory duty to weigh costs and benefits. The Rule here cannot be salvaged by the Commission's invocation of the financial crisis, the Dodd-Frank Act, and other diversionary tactics.

The Commission identified increased liquidity as the central reason for exempting investment companies from registration as CPOs in 2003, but cannot identify any portion of the rule release that addresses the effect that re-imposing a registration requirement will have on liquidity. Effects on liquidity are *always* an "important aspect of the problem" when regulating the financial markets. The obligation to address the topic is all the greater when increasing liquidity was the principal purpose of the rule now being reversed, figured prominently in the statutorily required cost-benefit analysis of the prior rule, and was an issue raised by numerous commenters in the new rulemaking.

Likewise, the Commission failed to consider the existing, comprehensive regulatory regime for investment companies, which was the other principal reason for the rule now being reversed. In *three* recent decisions, this Court has rejected attempts by the SEC to subject investment companies to greater regulation, con-

cluding that the SEC gave insufficient consideration to the comprehensive existing protections of the ICA, the costs of the new measures, or less restrictive alternatives. *See Bus. Roundtable v. SEC*, 647 F.3d 1144, 1154-55 (D.C. Cir. 2011); *Chamber of Commerce v. SEC*, 443 F.3d 890, 908 (D.C. Cir. 2006); *Chamber of Commerce v. SEC*, 412 F.3d 133, 142-45 (D.C. Cir. 2005). The CFTC seeks to subject investment companies to a new regulatory regime and two new regulatory masters. Yet it offers even less discussion of existing investment company regulations than the earlier rulemakings this Court invalidated.

As for considerations the agency *did* invoke in the rulemaking, without justification: The Commission repeatedly claimed "two significant benefits" for the Rule 4.5 amendments—minimum standards of fitness and competency, and a means to address wrongful conduct—although both benefits are already provided by the securities laws. The Commission now claims that the relevant passage of the rule release was referring to the benefits of regulating hedge funds, not investment companies. But the rule release makes no such distinction, and the Commission did not offer that explanation below. Indeed, it would come as a revelation to the court below, which also understood the "two significant benefits" to refer to investment companies.

Finally, the Commission tacitly concedes that it failed to consider the costs of the compliance obligations that result from registration, but insists that it like-

wise claimed no benefits from those obligations. That is incorrect. The Commission's claim that regulating a class of entities would be beneficial, despite not even knowing the "Compliance Rules" to which the newly regulated entities would be subject, demonstrates just how flawed this rulemaking was. The CFTC's decision to regulate first and determine the consequences later prevented it from measuring the true costs of CPO registration, even as it overstated the benefits based on assumptions about what the compliance requirements would be.

In these respects, and in the particulars of the Rule it adopted, the Commission erred. The Rule should be vacated.

ARGUMENT

I. The Commission Arbitrarily Reversed Its Prior Rulemaking Without Adequate Explanation.

The Commission determined in 2003 that investment companies should be excluded from CPO registration to bring valuable liquidity to the commodity markets. The instant rule release "offered no explanation—far less a 'reasoned one'—for [the Commission's] abrupt departure" from its prior determination. *Wis. Valley Improvement Co. v. FERC*, 236 F.3d 738, 748 (D.C. Cir. 2001).

A. The Commission Was Required To Address Its 2003 Rulemaking.

The Commission previously determined that exempting investment companies from registration would "benefit efficiency and competition by removing barriers to participation in the commodity interest markets, resulting in greater liquidi-

ty and market efficiency." 68 Fed. Reg. 47,221, 47,230 (Aug. 8, 2003). It determined that the exemption would "*increase* the available range of risk management alternatives." *Id.* (emphasis added). And, because investment companies are "otherwise regulated," *id.* at 47,223, the Commission found that there "should be no decrease in the protection of market participants and the public," *id.* at 47,230.

1. These findings are not "propositions for which scant empirical evidence can be marshaled" because further details are "unobtainable." *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 519 (2009). The CFTC determined, after conducting its statutorily required cost-benefit analysis, *see* 7 U.S.C. § 19(a), that it had a sufficient basis for concluding that the exemption would promote liquidity. It then had almost a decade of experience following the 2003 rulemaking from which to gather "empirical data" before deciding whether to reverse course. *Fox*, 556 U.S. at 519.

In unwinding this prior rulemaking, the Commission had to assess whether the change would jeopardize the benefits that it previously found would result from the rule. Indeed, the Commission concedes that *Fox* requires an "expla[nation] 'why the original reasons for adopting the displaced rule or policy are no longer dispositive,'" at least where the "'new policy rests on *factual findings* that contradict' those underlying the old policy.'" CFTC Br. 25, 29 (quoting 556 U.S. at 514-

15) (emphasis added). The claim that "there are no such findings" here (*id.* at 29) does not withstand scrutiny.

Even if the 2003 rulemaking had not contained "findings" regarding liquidity, that would not excuse the Commission from considering the issue before reversing course. The Supreme Court emphasized in *Fox* that "a reasoned explanation is needed for disregarding *facts and circumstances* that underlay or were engendered by [a] prior policy." 556 U.S. at 516 (emphasis added); *see also Manin v. NTSB*, 627 F.3d 1239, 1242-43 (D.C. Cir. 2011); *Dillmon v. NTSB*, 588 F.3d 1085, 1089-90 (D.C. Cir. 2009). The CFTC previously determined that the benefits of "greater liquidity," 68 Fed. Reg. at 47,230, were "facts and circumstances" that warranted an exemption from CPO registration. The Commission was obligated to explain why it now views those facts and circumstances differently. *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 56 (1983) ("While the agency is entitled to change its view," "it is obligated to explain its reasons for doing so.").

The Commission's failings in this respect are all the more pronounced because it was under a statutory obligation to "evaluat[e]" the "costs and benefits" of the Rule "in light of" "considerations of the efficiency, competitiveness, and financial integrity of futures markets." The "liquidity of the futures and option market" is a "particularly important" element of this inquiry. Proposed Rules: Revision of

Federal Speculative Position Limits and Associated Rules, 63 Fed. Reg. 38,525, 38,530 (July 17, 1998). Yet the Commission never explains how it could fulfill the cost-benefit requirement while omitting liquidity entirely from the analysis.

2. The Commission cannot evade its obligations by invoking a supposed change in regulatory "philosophy," under which previous deregulatory measures must give way to a new, pro-regulatory zeitgeist. *National Association of Home Builders v. EPA*, 682 F.3d 1032 (D.C. Cir. 2012) ("*NAHB*"), does not hold that "a change in 'philosophy' alone would have been sufficient," CFTC Br. 24. The agency there had "change[d] its mind," 682 F.3d at 1036, but the decisive consideration for this Court was that the agency "reevaluat[ed]" which "policy would be better in light of the facts," *id.* at 1038. The Court ruled that an agency could reach a different policy conclusion after (in petitioners' words) "merely revisit[ing] old evidence and arguments," *id.* at 1037—but "revisiting" earlier considerations is precisely what the CFTC *failed to do* in this case.

While *NAHB* illustrates that a change in regulatory priorities may justify reassessing a rule's costs and benefits, it does not establish that an agency can point to a new "philosophy" and—without "revisit[ing]" earlier "evidence and arguments"—call it a day. Instead, bedrock principles of administrative law require the agency to address key considerations underlying prior regulatory action that represent an "important aspect of the problem." *State Farm*, 463 U.S. at 43.

B. The Commission's Rule Release Failed To Consider The Effects On Liquidity Identified In The 2003 Rulemaking.

In the district court, the Commission did not claim that it had considered liquidity. It explained the rule release's neglect by stating that "other regulatory objectives became paramount in the aftermath of the financial crisis and Dodd-Frank." D.E. 29, at 7 n.5.

1. Before this Court, however, the Commission insists that it did not "leave the issue 'unaddressed'" because the rule release explained that "one reason for the amendments" was "to 'aid the Commission in examining large CPOs' roles as a source of liquidity in different asset classes.'" CFTC Br. 27 (quoting 76 Fed. Reg. 7,976, 7981 (Feb. 11, 2011)) (emphasis omitted). That is a completely different issue: The Commission's interest in *observing* liquidity does not answer whether the Rule will *cause it to be lost* because investment companies will avoid the commodity markets, as they did before the 2003 rulemaking. *See* Opening Br. 11. On that issue, the rule release is silent.

The Commission also maintains (at 27-28) that, because liquidity "simply means higher levels of investment activity," the rule release addressed the issue by discussing investment companies' "'increased trading activity in the derivatives area'" (quoting 77 Fed. Reg. 11,252, 11,255 (Feb. 24, 2012)). That increased activity was an intended benefit of the 2003 rule, and the instant rulemaking presumably will reduce it. Yet the Commission never considered those consequences, let

alone evaluated whether the amendments were nonetheless warranted. Indeed, the Commission has never explained—in the proposing release, the final release, two briefs filed in the district court, or its brief in this Court—what effect the Commission believes its Rule will have on liquidity. Nor did the Commission respond to numerous rulemaking comments pointing out that the Rule should not be adopted precisely because it would impair liquidity.

2. The Commission also falls back to its position below, claiming (at 28) that it was not required to address liquidity because "the CFTC reasonably no longer accepts market opacity as the price of high trading volume." No such explanation appears in the rule release, however, and for good reason: The Commission cannot reasonably claim that it will accept impaired liquidity as a trade-off for other benefits without even considering the *extent* of the impairment and the *extent* of the supposed benefits. Nor would the Commission's obligation to consider "important aspect[s] of the problem," *State Farm*, 463 U.S. at 43, as well as its duty to "evaluat[e]" the Rule's effects on the "efficiency, competitiveness, and financial integrity of futures markets," 7 U.S.C. § 19(a), permit it to disregard so cavalierly the possibility—indeed, probability—that the Rule will harm liquidity.

For similar reasons, invocation of "changed circumstances" (77 Fed. Reg. at 11,275) cannot excuse the Commission's failure. The financial crisis and Dodd-Frank did not alter the CFTC's obligations under the APA, or its cost-benefit obli-

gation under the CEA. And the Commission is wrong, in any event, to claim (at 11) that this Rule is "part of Dodd-Frank implementation." Dodd-Frank required hundreds of rulemakings, but not this one. The Commission claims that, "[a]s a result of Dodd-Frank, the CPO definition from which [registered investment companies] were excluded in 2003 no longer exists." *Id.* at 9. But Dodd-Frank merely *amended* that definition to encompass swaps. *See* Pub. L. No. 111-203, § 721(a)(6), 124 Stat. 1376, 1659-60 (2010). Congress left in place the CFTC's longstanding authority to exempt "otherwise regulated" entities from registration, and did nothing to suggest that this exemption should no longer be applied to investment companies. That is hardly surprising: As the Commission has conceded, there is no support for "attribut[ing] the financial crisis specifically to" investment companies. D.E. 15, at 24 n.10.[1]

Nor is Dodd-Frank somehow made relevant by the Commission's repeated invocation of the changes that law made to the Commodity Futures Modernization

[1] The Commission dismisses (at 32) as a "*proofreading* error" the district court's reliance on legislative history discussing "investment banks" to link investment companies to the financial crisis. But these are completely different types of entities, and legislative history pertaining to one does not implicate the other. Nor does this legislative history become relevant simply because it refers to "nonbank financial firms." The Commission claims that investment companies are a "typ[e] of nonbank financial fir[m]," *id.*, but its own authority states that "open-end investment companies might not be included within the statutory definition of 'nonbank financial company,'" 77 Fed. Reg. 21,637, 21,639 (Apr. 11, 2012).

Act of 2000 ("CFMA"), Pub. L. No. 106-554, 114 Stat. 2763A-365. *See*, *e.g.*, CFTC Br. 7, 28. The 2003 rulemaking was neither authorized nor required by the CFMA, just as the Commission's more recent Rule was not authorized or required by Dodd-Frank. Neither law is a *deus ex machina* that the Commission can deploy as a substitute for the analyses required under the APA and CEA.

3. Finally, the Commission claims for the first time (at 29) that its "harmonization" rulemaking relieved it of any obligation to address liquidity. According to the Commission, only its "Compliance Rules" could affect liquidity because (it insists) "[n]o commenter suggested that registration and CPO-PQR *alone* would drive [registered investment companies] out of markets." *Id.*

If the Commission believed that registration *simpliciter* would not affect liquidity, it was required to say so in the rule release—not just in its brief on appeal. *See SEC v. Chenery Corp.*, 318 U.S. 80, 87-88 (1943). Moreover, commenters did say that investment companies would be forced to incur "substantial costs" associated with "implementation of compliance controls and systems" designed to monitor compliance with the trading and marketing thresholds that trigger registration under the Rule, which could "reduc[e] liquidity." A-871 (SIFMA Comment). They warned that "mutual funds" that employ futures, options, or swaps might "cease doing so in the face of CPO *registration*." A-912 (Fidelity Comment) (emphasis added).

To be sure, other commenters emphasized that the so-called Compliance Rules would harm liquidity. *See* A-946 (CCMC Comment); A-984 (ICI Comment). But they never suggested that registration would not have that effect and had no reason during the comment period to separate out the issue, because the proposing release gave no hint that the final rule would require registration but not "Compliance." Indeed, the very term "Compliance Rules" rests on the mystifying premise that an informed decision to regulate, and assessment of the costs and benefits of doing so, can be divorced from knowledge of the "rules" that the regulated entities will have to "comply" with.

II. The Commission Did Not Meaningfully Assess The Costs And Benefits Of Its Rule.

Without discussing a single requirement that the securities laws impose on investment companies, the Commission claimed its Rule would provide benefits that, in fact, are already provided by SEC and FINRA regulation. The Commission compounded its error by conducting the rulemaking in a manner that made it impossible to determine, and therefore to assess, the Rule's true costs and benefits.

A. The Commission Failed To Evaluate The "Baseline" Provided By Existing Regulation Of Investment Companies.

An agency that must "evaluate" the benefits of a new rule cannot do so without determining what regulatory protections already exist. The Commission failed to meaningfully address that question, and, by neglecting to do so, also

failed to consider another principal rationale for the 2003 rule it was reversing—namely, that adequate protections already were provided by the securities laws.

1. The Commission tacitly concedes that investment companies are among the most highly regulated entities in the financial system, yet it "fail[ed] to determine whether, under the existing regime, sufficient protections existed," *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 178 (D.C. Cir. 2010), and "failed adequately to address whether the regulatory requirements of the ICA reduce the need for, and hence the benefit to be had from," the Rule. *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1154 (D.C. Cir. 2011).[2]

The Commission claims (at 51) that no analysis of the "baseline" was required because the SEC "does not monitor commodity markets or enforce the CEA." But this argument was rejected in *American Equity*. The state insurance regulators there did not monitor the securities markets or enforce the securities laws, and the SEC thus argued that state regulation "could not substitute" for regulation by the SEC. 613 F.3d at 178 (internal quotation marks omitted). Yet this

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[2] The Commission's *amici* suggest (at 6) that *subsidiaries* of investment companies are not adequately regulated by the SEC. But the Commission addressed those subsidiaries through a *different* portion of the rulemaking—rescinding a separate exemption under 17 C.F.R. § 4.13(a)(4)—that is not challenged here, and explained that subsequent to those amendments a subsidiary is not "entitled to exclusion simply because its parent company is a registered investment company." 77 Fed. Reg. at 11,260.

Court held that the SEC was nonetheless required to consider state insurance regulation in performing its cost-benefit analysis. *See id.*

In any event, the Commission's assertion (at 37) that the CFTC has "exclusive jurisdiction" over derivatives is inaccurate. Numerous SEC provisions govern investment companies' activities in the derivatives markets. *See* Opening Br. 7-9. These include disclosure obligations, periodic reporting requirements, and limitations on leverage. All are significant, but the leverage limits are particularly notable given the importance that the Commission's brief ascribes to leverage. *See*, *e.g.*, CFTC Br. 4; *see also*, *e.g.*, Dreyfus Strategic Investing & Dreyfus Strategic Income, SEC No-Action Letter (pub. avail. July 2, 1996) (applying leverage limitations to commodity derivative transactions).

Moreover, the SEC regime consists not only of specific requirements, but also of unique structural features—including independent board oversight—that govern investment companies *in all their activities*. *See*, *e.g.*, Cmte. on Fed. Regulation of Securities, ABA, *Report of the Task Force on Investment Company Use of Derivatives and Leverage* 45 (2010), *available at* http://apps.americanbar.org/buslaw/blt/content/ibl/2010/08/0002.pdf (independent board oversight should ensure that the investment manager "monitor[s] a fund's risk exposures generally, and from the use of derivatives in particular"). It is wrong to contend that this framework—designed to ensure that investment companies act in the interest of

shareholders at *all* times and with respect to *all* investments—has no relevance to the commodity markets. To the contrary, Congress granted the CFTC authority to exempt investment companies, *see* 7 U.S.C. § 1a(11), precisely because it recognized there might be unnecessary regulatory overlap that the Commission should avoid, *see* S. Rep. No. 97-384, at 80 (1982) (adopting exemptive authority to address concerns about entities "regulated by other Federal or State agencies").

2. Having failed to distinguish *American Equity* and *Business Roundtable*, the Commission attempts to limit the cases so that even the most facile consideration of existing regulation would suffice: It admits that the relevant portions of the rule release did not cite or discuss a single SEC regulation, but claims (at 49-50) it was sufficient for the release to have quoted—out of context—two stray remarks by the SEC or its officials.

The Commission first quoted an SEC release seeking comment on ways to enhance its regulation of investment companies' use of derivatives; the SEC explained that it had previously taken a "case-by-case" approach and "now seeks to take a more comprehensive and systematic approach." 76 Fed. Reg. 55,237, 55,239 (Sept. 7, 2011). In the Commission's jaundiced view, this statement is an admission that the SEC "had not developed a comprehensive and systematic approach to derivatives related issues." 77 Fed. Reg. at 11,255 (internal quotation marks omitted). But the fact that the SEC had proceeded on a "case-by-case" ba-

sis, and now seeks to be "more" systematic, hardly constitutes an admission that SEC regulation of investment companies is so deficient that the CFTC could ignore it.

The rule release also quoted a statement by the SEC's then-Chairman that some regulations "can lose their effectiveness when applied to derivatives." 77 Fed. Reg. at 11,255. The Commission's brief (at 49) omits the word "can" and mischaracterizes this statement as the "SEC's acknowledgement." The rule release, meanwhile, mentions only in a footnote that the statement was made in conjunction with efforts to *improve* SEC regulations. 77 Fed. Reg. at 11,255 n.37. Even if properly attributable to the SEC itself, awareness that its regulations can be improved—and willingness to undertake that effort—does not show that those regulations are ineffective, or that CPO registration is the cure.[3]

These drive-by references to the securities laws' comprehensive regulation of investment companies make a mockery of the reasoned decisionmaking required by the APA and CEA. Indeed, the SEC in *American Equity* undertook an analysis

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[3] The Commission claims (at 37) that "ICI told the SEC that 'no written SEC or staff guidance exists'" for swaps. The quoted language from ICI's comment letter merely observes that, because the SEC has regulated through no-action letters, it has not directly addressed how certain details of its regulations would apply to swaps. Ltr. from ICI to SEC 9 (Nov. 7, 2011). As ICI noted, this could give rise to "interpretive questions." *Id.* But it does not mean that SEC regulations are inapplicable to swaps, as the Commission implies.

that *exceeds* the Commission's less-than-minimal efforts here. The SEC acknowledged "recent and ongoing efforts by state insurance regulators," and even discussed particularly relevant laws. *See* 74 Fed. Reg. 3,138, 3,148 (Jan. 16, 2009). The Commission highlights the SEC's litigation position that state laws "'no matter how strong'" could not "'substitute for federal securities law protections.'" CFTC Br. 50 (quoting 613 F.3d at 178). But the SEC nonetheless examined those potential "substitute[s]" in its rule release, and this Court's determination that it did so inadequately is controlling here even if the SEC later maintained (unsuccessfully) that it was not required to consider state insurance regulation.

3. Finally, the CFTC argues (at 50) that it did not need to cite or discuss "a single SEC regulation" in this rulemaking because the securities laws "may" become "relevant" only in the rulemaking to determine the "Compliance Rules" for investment companies. That erroneous assertion aptly captures this rulemaking's indifference toward existing SEC requirements, and the unreasonableness of the Commission's claim that it can make an informed assessment of the need to regulate without knowing what—if any—"Compliance Rules" will be imposed.

B. The Commission Relied On Nonexistent Benefits.

The Commission cited "two significant benefits" for its registration requirement, but failed to consider whether those benefits are already provided by SEC and FINRA regulation—and in both cases, they are. And while the Commission

attempts to salvage the Rule as an information-gathering provision, that claim is equally unsupportable.

1. The Commission Invoked Specific Benefits Already Provided By The SEC.

a. The first supposed benefit of the Rule was promoting "minimum standards of fitness and competency." 77 Fed. Reg. at 11,254, 11,277. The Commission claimed to do so through the same types of requirements as the SEC regime: "periodic account statements, disclosure of risk, [and] audited financial statements." *Id.* at 11,280; *see also* Opening Br. 48-49.

The Commission now asserts (at 47) that this language referred only to "hedge funds." There is, however, not a single reference to hedge funds in this portion of the rule release; the release speaks generally of "registered entities," which under the Rule include investment companies. The court below certainly did not understand the release to draw such a distinction: The court's opinion relied on this very language, *see* A-95, as well as other passages from the same section of the release, *see* A-53, 56-58, 96-97. Indeed, the Commission's brief repeatedly cites statements from this section of the release as supporting its decision to regulate investment companies. *See* CFTC Br. 23-24, 35, 44 (citing 77 Fed. Reg. at 11,280). With the Commission, evidently, it's heads-I-win, tails-you-lose: So long as a statement is helpful, it applies to investment companies; but any harmful statements must implicitly be directed only to hedge funds. (Ironically, if this en-

tire section of the rule release *did* concern only hedge funds, then it would be even clearer that the Rule must be vacated for failing to evaluate the CEA cost-benefit factors, *see* 7 U.S.C. § 19(a), because that section is the *only* place where the release purported to address those factors.)

In any event, the Commission's alternative explanation of what it meant by "minimum standards of fitness and competency" is plagued by similar problems. The Commission observes (at 33) that the rule release cited legislative history that mentions qualifications testing, but that bare citation can hardly be interpreted as invoking testing as a basis for the Rule, particularly since the cited passage *also* refers to reporting requirements, and to the general "regulatory structure administered by the Commission under the Act." H.R. Rep. No. 97-567, at 48 (1982). And even if the Commission had invoked qualifications testing, FINRA already requires such testing for the many employees of broker-dealers that distribute investment company shares, and CFTC regulations exempt from NFA testing individuals who are tested by FINRA. *See* 17 C.F.R. § 3.12(h)(1)(ii). The Commission attempts to draw a distinction between "salespeople" regulated by FINRA and "operators" regulated by the NFA, but this analysis comes too late, *see Chenery*, 318 U.S. at 87, and in any event the Commission never explains why the distinction matters in this context.

The Commission also fails to take account of independent board oversight. As the Commission's own *amici* acknowledge, independent directors, "in the exercise of [their] fiduciary duty[,] may well have already ensured" that the "investment advisor has compliance personnel who are qualified in derivatives transactions and regulations." NFA Br. 17. The Commission should have considered these issues in the rule release, but did not.

b. The Commission claimed that the second benefit of registration was establishing "a clear means of addressing wrongful conduct" by registered entities, 77 Fed. Reg. at 11,254, 11,277, but the SEC already exercises significant enforcement powers, *see* Opening Br. 50. The Commission compounds this error in its brief, relying on registered CPOs' obligation to "'maintain books and records,'" CFTC Br. 35 (quoting 7 U.S.C. § 6n(3)(A)), even though the SEC imposes extensive bookkeeping requirements, *see* 15 U.S.C. §§ 80a-30(b), 80b-4.

The Commission suggests the SEC is irrelevant because it does not enforce the CEA. But a review of the CFTC's enforcement actions in 2012 reveals considerable overlap with the SEC: Most CFTC enforcement actions concern fraud, which the SEC addresses under myriad provisions applicable to investment companies and advisers. *See* 15 U.S.C. §§ 77q(a), 78j(b), 80a-33(b), 80b-6; 17 C.F.R.

§§ 240.10b-5, 270.34b-1, 275.206(4)-8.[4] Many other CFTC cases were brought on grounds that apply regardless of registration status. *See*, *e.g.*, 7 U.S.C. § 13b. For example, *Hunter v. FERC*, No. 11-1477, 2013 WL 1003666 (D.C. Cir. Feb. 7, 2013), relied on the CFTC's jurisdiction to pursue claims of market manipulation against "[a]ny person," 7 U.S.C. § 13(a)(2). According to the Commission's March 19 Rule 28(j) letter, *Hunter* shows there is a class of cases over which the CFTC has exclusive enforcement jurisdiction, but, if CPO registration is not necessary to pursue those cases, that does nothing at all to establish that *registration* would yield benefits.

2. The Registration Requirement Cannot Now Be Justified As An Information-Gathering Provision.

The Commission devotes an outsized portion of its brief to purported information-gathering benefits from reporting provisions that apply by virtue of registration. *See*, *e.g.*, CFTC Br. 37-41. These purported benefits are largely irrelevant to the registration requirement challenged by Appellants.

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[4] *See* CFTC, *2012 Enforcement Actions*, http://www.cftc.gov/LawRegulation/Enforcement/EnforcementActions/2012/index.htm. The Commission's Chairman emphasized that a chief rationale for the Rule was that, "if an investor in one of those funds *thinks they're being defrauded*, then we have the statutory authority to pursue it." *Webcast: Sixth Annual Capital Markets Summit* (Mar. 28, 2012) (pt. 2 at 25:41) (emphasis added), *available at* http://www.uschamber.com/webcasts/6th-annual-capital-markets-summit ("Capital Markets Webcast").

Commenters suggested that any information needed by the Commission could be gathered without requiring investment companies and advisers to register as CPOs, but that alternative went unaddressed in the rule release. *See* Opening Br. 16. The Commission now asserts that "Plaintiffs cite no authority by which the CFTC could require RICs that are not CPOs to file CPO-PQR." CFTC Br. 38. But the Commission already requires investment companies and advisers to file disclosures with the Commission to claim exclusion from registration, *see* 17 C.F.R. § 4.5(c), and if Commission believed it could not require additional disclosures it was required to explain why. Indeed, commenters suggested the Commission had such authority: "the Commission could amend Rule 4.5 to require entities relying on the rule to provide data." A-846 (ICI Roundtable Comment); *see also* A-1250-52 (inquiring whether CFTC could "change the exclusions and exemptions so that certain data have to be given to [the Commission] in order to qualify").

The Commission's encomium to the information-gathering benefits of its Compliance Rules also vastly overstates those benefits. The Commission downplays disclosures already made to the SEC—plucking out of context remarks from an SEC release that were not even quoted in the rule release, *see* CFTC Br. 10, 37—but mischaracterizes many aspects of those disclosure requirements. *See id.* at 39. The CFTC states that Form N-1A is filed only once in a fund's lifetime, when in fact it must be updated every sixteen months. *See* 15 U.S.C. § 77j(a)(3). It

states that Form N-1A is required only of open-ended funds—the most common type—but neglects to mention that similar forms are required of *all* investment companies. *See*, *e.g.*, Forms N-2, N-3, N-4, N-6. And it states that 17 C.F.R. § 210.12-13 requires disclosure of "major categor[ies] of investments," when that describes only the first column of required disclosures; the second and third columns require disclosures for each category on a contract-by-contract basis. Such are the perils of the Commission's failure to seriously assess the SEC regulatory framework during this rulemaking.[5]

The Commission also downplays the information that it already gathers under other rules, many of which (unlike the Rule here) are part of the regime established pursuant to Dodd-Frank. *See* § 727, 124 Stat. at 1696; *see also* 77 Fed. Reg. 2,136 (Jan. 13, 2012); 77 Fed. Reg. 1,182 (Jan. 9, 2012). These regulations apply without regard to registration status, and are intended to provide "*complete data concerning all swaps* subject to the Commission's jurisdiction." 77 Fed. Reg. at

[5] The CFTC's Chairman stated that forms filed with the SEC would suffice to provide any information that the CFTC needs. *See* Capital Markets Webcast, *supra* (pt. 2 at 25:18). The Commission asserts (at 38 n.11) that the Chairman was not talking about investment companies, but that is inaccurate. The Chairman mentioned Form PF, as the Commission observes, but did so to draw an analogy: He explained that "we're saying the same thing" with respect to investment companies, and elaborated that "[o]nce they're registered we ought to be able to take the forms from the other agency."

2,138 (emphasis added). The benefit of additional reporting is thus as unsubstantiated as it is irrelevant to the rationales actually advanced in the rule release.

C. The Commission Relied On Uncertain Benefits Even As It Improperly Obscured The Rule's Costs.

The Commission also erred by adopting the Rule in a manner that made it impossible to fully consider its costs, and by discounting those costs as uncertain even as it relied on equally uncertain benefits.

1. The Commission performed a flawed cost analysis of the registration requirement because it omitted any consideration of the Compliance Rules that are part and parcel of registration. *See* Opening Br. 51. On appeal, the Commission's primary response to this flaw is to engage in misdirection, claiming (at 15) that Appellants' challenge to the Rule is *actually* a challenge to the Compliance Rules. That is incorrect.

The challenged Rule requires certain investment companies and their advisers to register as CPOs, and that registration requirement has always been the "focu[s]" (CFTC Br. 15) of Appellants' claims. *See* A-248-49. To be sure, Appellants have argued that one of the *problems* with the registration requirement is that the Commission imposed it without knowing which Compliance Rules would apply, and thus what its true costs would be. *See* A-253, 262. But that is an argument that the Commission could not conduct the cost-benefit analysis necessary to adopt the *registration* requirement—a key objective of which assuredly is to secure

"compliance" with the Commission's "Compliance Rules." The registration requirement is indisputably ripe for consideration, and neither the Commission nor the district court has ever claimed otherwise. *See*, *e.g.*, *La. Pub. Serv. Comm'n v. FERC*, 522 F.3d 378, 397 (D.C. Cir. 2008) (per curiam).

The CFTC's inability to assess the costs of registration is particularly problematic because it simultaneously claimed benefits from the yet-to-be-adopted Compliance Rules. Although the Commission now claims otherwise, the rule release stated that it was "modifying [Section] 4.5" because it believed "entities that are offering services substantially identical to those of a registered CPO should be subject to substantially identical regulatory obligations." 77 Fed. Reg. at 11,255; *see also* 76 Fed. Reg. at 7,984 (expressing concern that otherwise-regulated entities would "avoid registration and compliance obligations"). It is precisely these "regulatory obligations" and "compliance obligations" that remain to be determined.

The Commission again responds (at 47) that any portion of its cost-benefit analysis claiming benefits from the Compliance Rules should be interpreted as applying only to hedge funds. The rule release draws no such distinction. And if the Commission is to be believed that the cost-benefit analysis in that portion of the release (77 Fed. Reg. at 11,280) does not address investment companies, that creates a different, more obvious problem for the agency: It failed to consider the

statutorily-required cost-benefit factors as they apply to investment companies. *See supra* at 17-18.

2. The Commission does not dispute that it lacked the data necessary to assess the impact of its Rule. *See* Opening Br. 58-59. Nor does it defend the comment by the staff member in charge of the rulemaking that, "[e]ven though my training" would "say you get the data first, I'm not seeing it in this current political and budgetary environment." A-1253.

The Commission instead asserts that commenters ought to have offered the data themselves. But the Commission cannot shift its statutory burden, and in any event commenters *did* offer data. ICI, for example, provided survey results demonstrating that the Rule would target entities without significant exposure to the commodity markets. *See* A-982 (ICI Comment). And other commenters proposed ways the Commission could gather additional market data. *See*, *e.g.*, A-846 (ICI Roundtable Comment). The Commission failed both to gather adequate data and to analyze the data before it.

3. The Commission failed to ascertain the Rule's true costs in any event because of the uncertainty regarding the definition of "swap" and the margin requirements for swap transactions. The Commission responds that it had already proposed a definition of swap, but a proposal is just that—a proposal. *See* 5 U.S.C. § 553(c). Moreover, the Commission's brief addresses only *one* of the *three* then-

ongoing rulemakings relied on by Appellants. The Commission fails to address its rulemaking establishing margin requirements for uncleared swap transactions or the Treasury's rulemaking determining whether to exempt certain foreign exchange swaps and forwards. *See* Opening Br. 57. Commenters relied on both rulemakings to illustrate the Rule's hidden costs. *See* A-945 (CCMC Comment).

III. The Commission's Rule Suffers From Other Serious Deficiencies.

The Rule is deficient in several other respects, all of which the Commission tries but fails to fix in its brief.

1. *Inclusion of Swaps Within the Registration Thresholds.* In the rule release, the Commission said that it had no idea how to write a Rule excluding swaps from the registration thresholds: "If swaps were excluded, any swaps activities undertaken by a registered investment company would result in that entity being required to register . . . ." 77 Fed. Reg. at 11,258. Confronted with the absurdity of this reasoning, the Commission attempts to direct the Court's focus elsewhere, claiming (at 55) that it included swaps because "[e]nhancing oversight of swaps markets was a core purpose of the Final Rule." To support this argument, the Commission cobbles together sentence fragments taken out of order from various portions of the rule release, but even this Frankenstein quotation does not advance the Commission's newfound rationale. *See id.* at 55-56. If oversight of swaps truly were a "core purpose" for the Rule, surely it would have been easier to find a

quote identifying that as the reason for including swaps in the registration thresholds. The APA does not recognize certain purposes of a rule to be so important that they may be left unmentioned at critical junctures.

2. *Definition of Bona Fide Hedging*. As Commissioner Sommers noted, it was irrational for the CFTC to defend the definition of *bona fide* hedging on the ground that it included transactions "offset" by exposure in other markets, when the same is true of a broad variety of risk mitigation transactions. 77 Fed. Reg. at 11,344. The Commission claims (at 58) that it would be difficult to choose another definition, as commenters proposed multiple alternatives. But a proliferation of alternatives is no reason to disregard *all* of them.

Quoting an ICI comment that it would be "'very complicated'" to formulate a definition of an offsetting transaction, the Commission suggests (at 58) that alternative definitions might not "offset as intended." Yet commenters pointed out that the CFTC *itself* has adopted different definitions in other contexts. Opening Br. 62. The Commission responds (at 58 n.20) that "other rules reflect different policy considerations," but that does not explain why those definitions would not have worked *here*—a matter that the Commission was required to, but did not, address.

3. *Adoption of Specific Trading Threshold*. The Commission acknowledges (at 54) that its 2003 rulemaking rejected a five percent threshold as too low, but responds that the goal then "was to *reduce* oversight," whereas the goal now is

"to *increase*" it. An asserted desire to "increase" regulation is insufficient to justify a specific regulatory threshold. *See supra* at 6. The Commission also points out that the 2003 regulation adopted a five percent threshold in a *different* context, but does not explain how it could ignore that regulation's rejection of a five percent threshold in the *relevant* context of registration under Section 4.5 of its regulations. *See* Opening Br. 64.

The Commission claims (at 54) that the net notional test cures its failure to justify the five percent threshold. But the Commission was required to justify each aspect of its Rule, including the five percent threshold, and cannot rely on *other* aspects of the Rule to discharge that responsibility. In any event, although the Commission has been uncertain how the net notional test will function, *see* A-119, it is clear that which test is more restrictive depends on a fund's particular investment mix. Indeed, when the possibility of such a test was mentioned at the roundtable held in conjunction with the rulemaking, an NFA participant explained that the "net notional number gets distorted really quickly" for certain types of investments. A-1239.

IV. The Commission Provided Inadequate Opportunity For Notice And Comment.

The Commission acknowledges (at 60) that the "cost-benefit section" of its proposing release was "relatively brief." It nonetheless maintains that the "proposal met the APA's requirement for notice" because the Commission identified its

"approach" and "invited commenters to submit data." *Id.* But the fact that Appellants "could have submitted cost data on registration and reporting" (*id.*) hardly means they were provided with sufficient notice of the CFTC's *own* thinking regarding costs and benefits so that they could meaningfully comment. This Court has held that the SEC's "extensive reliance upon extra-record materials in arriving at its cost estimates" required "further opportunity for comment." *Chamber of Commerce v. SEC*, 443 F.3d 890, 901 (D.C. Cir. 2006). If that is so where the agency relied on at least *some* "information in the existing record," *id.* at 902 (internal quotation marks omitted), it is all the more clearly required where no such information existed.

The Commission also errs in claiming (at 61) that it was not required to give notice of the seven-factor marketing test on the theory that it is "a policy statement reflecting how the Commission will consider compliance with the Rule 4.5 marketing restriction," rather than part of the Rule's text. The Commission cannot evade notice-and-comment by including new substantive standards in the rationale for a rule. *See Syncor Int'l Corp. v. Shalala*, 127 F.3d 90, 96 (D.C. Cir. 1997) (agency cannot promulgate substantive provisions through policy statement).

V. This Court Should Vacate The Commission's Rule.

The CFTC fails to address any of Appellants' arguments for vacatur. *See* Opening Br. 65-66. The Commission does argue (at 19-20 n.4) that vacatur is in-

appropriate because the provisions of the Rule are severable from other provisions not challenged here, but that is irrelevant: Appellants have never argued that unchallenged provisions ought to be vacated, or that the amendments to Section 4.5 should be vacated based on flaws in other provisions. And while the Commission cites the "national interest in 'improving accountability and transparency in the financial system,'" *id.* (quoting 77 Fed. Reg. at 11,252), the basis for Appellants' challenge is that the Commission has not shown any need for its regulation of investment companies and their advisers; it puts the cart before the horse to argue the Rule should not be vacated because of its purported benefits.

Where an agency "relied on multiple rationales" and "at least one of the rationales is deficient," this Court "will ordinarily vacate" unless it is "certain" the rule would have been adopted "absent the flawed rationale." *Nat'l Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831, 839 (D.C. Cir. 2006). There is no such certainty here, and there are multiple flawed rationales.

CONCLUSION

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

Dated: April 3, 2013

Respectfully submitted,

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Dated: April 3, 2013

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CERTIFICATE OF SERVICE

Pursuant to Federal Rule of Appellate Procedure 25(d), I hereby certify that on this 3d day of April, 2013, the foregoing Reply Brief for Appellants was electronically filed with the Clerk of Court for the United States Court of Appeals for the District of Columbia Circuit using the CM/ECF system. I also hereby certify that I caused eight paper copies to be hand delivered to the Clerk's Office.

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