IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

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

Plaintiffs,

v.

UNITED STATES COMMODITY FUTURES TRADING COMMISSION,

Defendant.

Civil Action No. 1:12-cv-00612 (BAH)

PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT

COME NOW PLAINTIFFS Investment Company Institute and Chamber of Commerce of the United States of America and hereby respectfully move this Court to enter summary judgment for Plaintiffs on all claims.

This motion is supported by the Memorandum of Points and Authorities filed concurrently herewith.

Dated: May 18, 2012

Respectfully submitted,

/s/ Eugene Scalia

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PLAINTIFFS' MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF MOTION FOR SUMMARY JUDGMENT

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INTRODUCTION

Mutual funds and other "investment companies" are among the most comprehensively regulated entities in the U.S. financial system. The Securities and Exchange Commission ("SEC") regulates practically every aspect of the business of registered investment companies, as well as the "advisers" that manage them. And other service providers to investment companies are regulated both by the SEC and by a self-regulatory organization for the securities industry. For this reason, the Commodity Futures Trading Commission ("CFTC," or "Commission") concluded in a 2003 rulemaking that investment companies were "otherwise regulated" entities that did not require additional regulation by the CFTC. Moreover, the Commission concluded in its 2003 rulemaking, exemption from CFTC regulation would increase investment companies' participation in the commodity interest markets, which would "benefit efficiency and competition," "resulting in greater liquidity and market efficiency" with benefits for all market participants.

This case concerns the Commission's summary reversal of that 2003 decision in a rulemaking earlier this year. The Commission admitted in its final rule release that subjecting investment companies to additional regulation would impose "significant burdens," yet it identified no problems or abuses that had arisen since 2003 that justified regulation, and pointed to no protections resulting from its new Rule that were not already supplied by the SEC. Indeed, in violation of one of the most basic requirements for agency rulemaking, the Commission scarcely even acknowledged the rationale for its 2003 decision, and utterly failed to explain why that rationale was mistaken and regulation was required.

The CFTC has a special responsibility under the Commodity Exchange Act to consider the costs and benefits of its actions; this obligation is similar to a requirement for the SEC that has led the D.C. Circuit to invalidate SEC rules in four recent cases. In the rulemaking at issue here, the CFTC precisely replicated some of the errors committed by the SEC, and then com-

pounded those errors by proclaiming that the Rule's benefits justified its costs even though the Commission admittedly lacked two types of information necessary to make that determination.

First, the Commission was unable to evaluate one of the most significant potential costs of the Rule: the requirement that investment companies and their advisers make numerous disclosures and filings under rules administered by the CFTC and the self-regulatory organization for the futures industry that overlap—and in some instances conflict—with disclosures and filings required by the SEC. The Commission admitted that it must revise its requirements to "harmonize" them with the SEC's, and admitted as well that, since those requirements must change, it was unable at this time to evaluate the "paperwork" burdens imposed by the Rule as required by the Paperwork Reduction Act. It follows that the Commission lacked sufficient information to appraise the Rule's burdens and costs for purposes of the Commodity Exchange Act as well, yet the Commission arbitrarily declared that its cost-benefit analysis under that Act was complete and that the Rule's benefits justified its costs.

Second, the Rule is much more restrictive than its pre-2003 counterpart because it covers "swaps"—financial instruments that are generally understood to involve exchanges of payments based on changes in the value of underlying assets, but which will not be fully defined until the completion of a separate rulemaking that is still underway. In resolving nonetheless to adopt the Rule and extend it to financial instruments that are not yet fully defined, the Commission once again put the cart before the horse and proclaimed its Rule to be cost-justified without a proper understanding of what its costs will be.

These actions by the Commission were arbitrary and capricious, and violated the Commodity Exchange Act and the Administrative Procedure Act. For these and other reasons, the Commission's amendments to Sections 4.5 and 4.27 of its regulations must be vacated.

STATEMENT OF FACTS

A. Regulation Of Registered Investment Companies

Investment companies—including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts—pool money from investors to purchase securities.[1] An investment adviser manages the investment company for the benefit of investors.[2] Investment companies are also generally affiliated with other service providers, including the underwriters that distribute investment company shares for sale.[3]

Investment companies are required to register with the SEC, and they are the only entities in the American financial system regulated by all four major federal securities laws: the Investment Company Act of 1940 ("ICA"), 15 U.S.C. § 80a-1 *et seq.*, the Investment Advisers Act of 1940 ("IAA"), 15 U.S.C. § 80b-1 *et seq.*, the Securities Act of 1933 (the "'33 Act"), 15 U.S.C. § 77a *et seq.*, and the Securities Exchange Act of 1934 (the "'34 Act"), 15 U.S.C. § 78a *et seq.* As a result, they are among the "most regulated types of companies in the United States." Clifford E. Kirsch, 1 *Mutual Funds and Exchange Traded Funds Regulation* § 1:4.1 (3d ed. 2011); *see also* Louis Loss *et al.*, 1 *Securities Regulation* 379 (4th ed. 2006) ("[T]he Investment Company Act is the most complex of the entire SEC series.").

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[1] An investment company is defined by the Investment Company Act of 1940, with certain caveats, as an issuer that "holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities" or that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets." 15 U.S.C. § 80a-3(a)(1).

[2] An investment adviser is defined by the Investment Advisers Act of 1940 as a "person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." 15 U.S.C. § 80b-2(a)(11).

[3] For a discussion of the structure of investment companies, including an explanation of the differences between the various types of investment companies, see ICI Factbook, Appendix A, http://www.icifactbook.org/fb_appa.html.

Distributors of investment company shares are also subject to the regulatory oversight of the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory organization with extensive authority and responsibility conferred by federal law.[4] FINRA licenses the individuals and firms that distribute shares in investment companies, issues substantive regulations, and disciplines licensed entities that fail to comply with the securities law or with FINRA's own rules and regulations. FINRA is empowered to levy significant sanctions, including suspension and disbarment.

The regulatory regimes of the SEC and FINRA subject investment companies and their service providers to myriad regulations covering virtually every aspect of investment companies' business, including:

- ***Registration and Disclosure Obligations.*** Investment companies and their advisers are each required to file separate registration statements with disclosures spanning a broad variety of topics, including fundamental characteristics and investment risks of the fund; investment strategies; past performance of the fund; fees and expenses; legal proceedings; and financial highlights. *See* 15 U.S.C. §§ 80a-8(b), 80b-3; *see also* Forms N1-A, N-2, and ADV. Disclosures are made available to the public, including on the SEC's website.[5]
- ***Periodic Reporting Requirements.*** Investment companies are required to publicly file quarterly, semi-annual, and annual reports containing financial information and other disclosures, and to provide copies of their semi-annual and annual reports to investors. *See* 15 U.S.C. § 80a-29; 17 C.F.R. §§ 270.30b1-5, 270.30b2-1, 270.30e-1.

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[4] *See* FINRA Rules, *available at* http://finra.complinet.com///_.html?=&element _id=607& record_id=609.

[5] *See* SEC, Search Company Filings, *available at* http://sec.gov/search/search.htm.

- ***Conflicts Provisions.*** Investment companies are subject to conflict of interest provisions, including a requirement of independent board oversight, 15 U.S.C. § 80a-10; prohibitions on transactions between investment companies and their affiliates, *id.* § 80a-17; and restrictions regarding custody of fund assets, *id.*
- ***Compliance Policies.*** Investment companies and their advisers each must employ chief compliance officers, and must institute compliance policies and procedures. *See* 17 C.F.R. §§ 270.17j-1, 270.38a-1, 275.204A-1, 275.206(4)-7.
- ***Qualifications Testing.*** FINRA requires individuals who distribute investment company shares to pass competency examinations. *See* FINRA Rule 1230. The CFTC generally treats these examinations as sufficient to determine that a person is qualified to sell commodity pool interests as well. *See* 17 C.F.R. § 3.12(h)(1)(ii).
- ***Limitations on Leverage.*** Investment companies are subject to restrictions intended to limit risk associated with leverage, that is, transactions that could result in a loss greater than the amount initially invested. 15 U.S.C. § 80a-18. These include certain commodity transactions.[6] *See* Securities Trading Practices of Registered Investment Companies, 44 Fed. Reg. 25,128, 25,132 (Apr. 27, 1979). The SEC periodically reviews its policies and guidance on use of these transactions to evaluate them in light of recent developments.[7]

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[6] The leverage restrictions apply broadly to certain "derivatives" transactions, that is, transactions in which parties agree to make payments based on the value of an underlying asset. As a result, the rules apply to a broad variety of commodity interests regulated by the CFTC.

[7] *See* Use of Derivatives by Investment Companies Under the Investment Company Act of 1940, 76 Fed. Reg. 55,237 (Sept. 7, 2011); *see also* Press Release, SEC, SEC Staff Evaluating the Use of Derivatives by Funds (Mar. 25, 2010), *available at* http://www.sec.gov/news/press/ /2010-45.htm; Registered Investment Company Use of Senior Securities—Select Bibliography, *available at* http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm.

- ***Anti-Fraud Provisions.*** Investment companies and affiliated persons are subject to multiple anti-fraud provisions. *See* 15 U.S.C. §§ 77q(a), 78j(b), 80a-33(b), 80b-6; 17 C.F.R. § 240.10b-5; FINRA Rule 2020.

The SEC's broad powers include the authority to conduct investigations and issue subpoenas, 15 U.S.C. §§ 80a-41, 80b-9, and to inspect the books and records of an investment company or its adviser "at any time," *id.* §§ 80a-30(b), 80b-4. It may initiate administrative proceedings, where available sanctions include monetary penalties, disgorgement, cease and desist orders, censure, and revocation of registration. *See id.* §§ 80a-9, 80b-3. And it may pursue civil and criminal remedies in judicial proceedings. *See id.* §§ 80a-41, 80a-48, 80b-14. Congress enhanced these enforcement powers after the 2008 financial crisis in the Dodd-Frank Act Wall Street Reform and Consumer Protection Act by, among other things, authorizing civil penalties in administrative proceedings. *See* Pub. L. No. 111-203, §§ 921-929U, 124 Stat. 1376, 1841-67 (2010).

Investment companies and their advisers are also currently subject to CFTC regulations that apply broadly to market participants regardless of registration status. These include CFTC large-trader reporting requirements under 17 C.F.R. Parts 15-21, which require certain participants in the commodities markets to make extensive disclosures regarding, among other things, the trader's registration status, affiliations, and accounts. And investment companies and their advisers are subject to the CFTC's recently adopted swap reporting and recordkeeping requirements. *See* 77 Fed. Reg. 2,136 (Jan. 13, 2012); 77 Fed. Reg. 1,182 (Jan. 9, 2012).

B. Regulation Of Commodity Pool Operators

A commodity pool operator ("CPO") is an entity that pools money from investors "for the purpose of" trading in commodity interests. Entities that meet the definition of a CPO are subject to an entirely separate regulatory regime administered by the CFTC under the Commodi-

ty Exchange Act ("CEA"). The CFTC has statutory authority to exclude entities from the definition of a CPO, and hence from the registration requirement and its attendant regulatory burdens. *See* 7 U.S.C. § 1a(11).[8]

Entities that meet the statutory definition of a CPO and that are not exempted by the CFTC are subject to a regulatory regime that covers substantially the same areas as the SEC's regulation of investment companies. CPOs must register with the CFTC, 7 U.S.C. § 6k, and are subject to provisions governing reporting and disclosure to investors, 17 C.F.R. §§ 4.21-22, 4.24-25, recordkeeping, *id.* § 4.23, segregation of investor assets, *id.* § 4.20, and registration and reporting obligations, 7 U.S.C. §§ 6k, 6m, 6n. In addition, registered CPOs are required to become members of the self-regulatory organization for the commodities industry: the National Futures Association ("NFA"). *See id.* § 21(m). Like FINRA, the NFA has authority to promulgate rules and regulations for its members and to enforce compliance, including through suspension or disbarment. The NFA imposes reporting and disclosure obligations, restrictions on the content of promotional materials, and qualification testing of associated persons.[9]

Since 1984, the Commission has exercised its authority, through Section 4.5 of its regulations, to exempt a wide variety of "otherwise regulated" entities—including registered investment companies, as well as banks, trust companies, insurance companies, and pension plans—from these regulatory burdens. *See* 49 Fed. Reg. 4,778, 4,778 (Feb. 8, 1984). Just two years ago, the Commission reiterated that it had excluded these entities from its regulations of CPOs because they were "otherwise highly-regulated." 75 Fed. Reg. 54,794, 54,795 (Sept. 9, 2010).

[8] The CEA defines a CPO as a person engaged in the business of operating an investment trust, syndicate, or similar enterprise that, "in connection therewith, solicits, accepts, or receives from others, funds, securities, or property . . . for the purpose of trading in commodity interests," including any "commodity for future delivery, security futures product, or swap." 7 U.S.C. § 1a(11)(A).

[9] *See* NFA Rules, *available at* http://www.nfa.futures.org/NFAManual.

Prior to 2003, Section 4.5 of the Commission's regulations required persons claiming exclusion for any of these otherwise regulated entities to file a notice of eligibility representing that they met two threshold requirements, referred to as the "trading" and "marketing" thresholds. Investment companies responded to these requirements by generally restricting their investment in commodity interests to meet these conditions, so that they would not be subject to the overlapping regulatory jurisdiction of both the SEC and the CFTC. *See*, *e.g.*, David E. Riggs & Charles C.S. Park, *Mutual Funds: A Banker's Primer*, 112 Banking L.J. 757, 760-61 (1995) ("While mutual funds can, and do, invest in commodity futures contracts, their investments in such contracts are limited so as to avoid classification and regulation as [CPOs].").

In 2003, after public notice and opportunity for comment, the Commission amended Section 4.5 to effectively exclude all otherwise regulated entities covered by that regulation—again including registered investment companies—from the definition of a CPO, by eliminating trading or marketing thresholds. *See* 68 Fed. Reg. 47,221, 47,231 (Aug. 8, 2003) ("2003 Adopting Release"). Regulation of these entities was unnecessary, the Commission determined, because they are "otherwise regulated." *Id.* at 47,223. The Commission further explained that the trading threshold had come to limit the activities of these entities "to a much greater extent" than intended, due to changes to margin levels for certain futures contracts. *See* 68 Fed. Reg. 12,622, 12,625 (Mar. 17, 2003) ("2003 Proposing Release"). The Commission's amendments eliminating the trading and marketing thresholds were "intended to allow greater flexibility and innovation," the Commission said, "by modernizing the requirements for determining who should be excluded from the CPO definition"; the change would "encourage and facilitate participation in the commodity markets by additional collective investment vehicles and their advisers, with the added benefit to all market participants of increased liquidity." *Id.*

The Commission's 2003 analysis of costs and benefits identified several benefits and no costs. The amendments would "benefit efficiency and competition by removing barriers to participation in the commodity interest markets, resulting in greater liquidity and market efficiency." 2003 Adopting Release at 47,230. The amendments would also "increase the available range of risk management alternatives" by permitting investment companies to take advantage of a wider range of trading strategies, thus promoting sound risk management practices. *Id.* Conversely, the Commission concluded that there "should be no decrease in the protection of market participants and the public" because the amendments merely relaxed the Commission's regulatory requirements "in order to be consistent with existing requirements under the federal securities laws and the SEC's rules." *Id.*

C. The Commission's Amendments To Sections 4.5 and 4.27

In the Rule at issue in this case, the Commission amended Section 4.5 to impose trading and marketing thresholds for investment companies even stricter than those it eliminated in 2003. The Commission, however, did *not* impose trading and marketing thresholds on other "otherwise regulated" entities covered by Section 4.5.

The trading threshold imposed by the Rule requires a person claiming exclusion to represent that the investment company uses futures, options, and swaps solely for bona fide hedging purposes, meaning risk management transactions that offset exposure in the physical commodity markets. 77 Fed. Reg. 11,252, 11,283 (Feb. 24, 2012); *see also* 77 Fed. Reg. 17,328 (Mar. 26, 2012). Alternatively, a person may represent that (1) the initial margins and premiums required to establish non-bona-fide hedging positions in futures, options, and swaps will not exceed five percent of the liquidation value of the investment company's portfolio; or (2) under an "alternative net notional test," the "aggregate net notional value" of such positions "does not exceed 100 percent of the liquidation value of the pool's portfolio, after taking into account unrealized prof-

its and unrealized losses on any such positions." 77 Fed. Reg. at 11,283. This largely mirrors the pre-2003 trading threshold, although the net notional test is new. The trading threshold imposed by the Rule will, however, be significantly more restrictive than the pre-2003 threshold because it includes trading in swaps. *See*, *e.g.*, Vanguard, Comment (Apr. 12, 2011), at 3-4.

Under the new marketing test, a person must represent that the investment company will not market its fund as a commodity pool or as a means to trade in commodity futures, options, or swaps markets. 77 Fed. Reg. at 11,283. Aside from the inclusion of swaps, this is essentially identical to the pre-2003 marketing threshold. However, in the explanation accompanying the Rule, the Commission identified seven new factors that would guide the application of the test. *Id.* at 11,259. These factors were not identified in the initial rule proposal.

In the same rulemaking, the Commission amended Section 4.27 of its regulations to require CPOs, including investment company advisers, to file a new Form CPO-PQR. Some entities will have to file the report with the Commission on a quarterly basis. *See* 77 Fed. Reg. at 11,285-86, 11,295-96.

1. The Commission's Stated Rationale For Regulating Investment Companies And Commenters' Objections

In the initial notice proposing its rule change, the Commission offered no explanation for its departure from the rationale of its 2003 rulemaking, and provided less than a full sentence of analysis of the costs and benefits associated with the new registration thresholds. The proposal provoked sharp criticisms from dozens of rulemaking commenters.

The Commission adopted the Rule on February 24, 2012. In the accompanying final rule release, the Commission claimed the Rule was necessitated by "increased derivatives trading activities by entities that have previously been exempted from registration with the Commission, such that entities now offering services substantially identical to those of registered entities are

not subject to the same regulatory oversight." 77 Fed. Reg. at 11,275. To support this conclusion, the Commission cited a petition for rulemaking that identified "three entities" that had launched investment companies marketed to investors "as commodity futures investments." NFA, Petition for Rulemaking (Aug. 18, 2010), at 3-4; *see also* 76 Fed. Reg. 7,976, 7,983 (Feb. 11, 2011). Commenters questioned the extent to which such activity extended beyond the three firms identified by the NFA, and presented data showing that the Rule, as proposed by the Commission, would sweep far more broadly. *See* ICI, Comment (Apr. 12, 2011), at 19-20.

Commenters also questioned why participation by investment companies in the commodity markets justified the Rule in any event, and pointed to the Commission's own rationale for eliminating the thresholds in 2003. They argued that existing SEC regulations "obviate the need" to subject investment companies and their advisers "to redundant or inconsistent regulation." Vanguard Comment, at 5; *see also* SIFMA, Comment (Apr. 12, 2011), at 4 ("CPO registration would create needless, duplicative compliance obligations."). And commenters argued that the "fact that registered investment companies are providing retail investors greater access to the commodities market . . . through an investment vehicle they are familiar with, that is highly regulated, and that will limit an investor's losses to the amount such investor invested . . . should be encouraged and facilitated," rather than burdened and discouraged. Morgan Lewis, Comment (Apr. 12, 2011), at 6.

The Commission's final rule release nonetheless failed to address the agency's own conclusion in 2003 that registration of investment companies was unnecessary in light of existing SEC regulation. Its discussion of the Section 4.5 amendments did not cite a single SEC regulation, assess the protections afforded by those regulations, or address how SEC regulation related

to CFTC regulation of CPOs.[10] Several commenters had provided a detailed overview of existing SEC regulation and explained at length how those regulations would overlap and conflict with the Commission's regulations of CPOs. *See*, *e.g.*, ICI Comment App. A; Fidelity Investments, Comment (Apr. 12, 2011), at 3-4. The Commission made no specific response to these comments. It also did not mention its 2003 conclusion that eliminating the trading and marketing thresholds would promote liquidity and market efficiency, thus benefitting all market participants, by increasing investment companies' participation in the commodity markets.

The Commission also sought to justify the Rule on the ground that "Dodd-Frank has given the Commission a more robust mandate to manage systemic risk," commonly understood to mean risk to the financial system generally. 77 Fed. Reg. at 11,275. Registration would provide "reliable information" to "execute this mandate," the Commission said. *Id.* Commenters, however, had pointed out that Dodd-Frank did not require the proposed amendments to Section 4.5, and that there was no evidence that investment companies' participation in the commodities markets posed *any* risk, much less systemic risk. *See*, *e.g.*, ICI Comment, at 6-7. Commenters also pointed out that the "reliable information" that the Commission sought could be obtained by other means, including CFTC disclosure requirements that apply generally to all market participants, and publicly available disclosures already made by investment companies to the SEC. *See*, *e.g.*, Invesco, Comment (Apr. 12, 2011), at 5; Dechert, Comment (Apr. 12, 2011), at 10.

Finally, the Commission sought to justify its Rule on the ground that "entities that are offering services substantially identical to those of a registered CPO should be subject to substantially identical regulatory obligations." 77 Fed. Reg. at 11,255. Commenters, however, observed

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[10] The Commission did cite SEC regulations in its discussion of amendments to Sections 4.7 and 4.13, which are not relevant to the amendments challenged here. *See* 77 Fed. Reg. at 11,261, 11,263.

that the Rule would create new asymmetries: Investment companies (and their advisers) that meet the registration thresholds would be subjected to dual regulation, whereas other CPOs would not; and, unlike investment companies, other "otherwise regulated" entities, including insurance companies, banks, trust companies, and pension plans, would continue to rely on the Section 4.5 exemption without regard to trading or marketing thresholds. *See*, *e.g.*, ICI Comment, at 8. The Commission offered "no justification for imposing additional burdens on registered investment companies that, ironically, are subject to far more regulation and oversight than are other entities offered to, or operated for the benefit of, retail investors that may continue to rely on Rule 4.5 in its current form." *Id.*

2. The Commission's Analysis Of Costs And Benefits

Section 15(a) of the CEA requires that "[t]he costs and benefits of the proposed [rule] shall be evaluated in light of—(A) considerations of protection of market participants and the public; (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets; (C) considerations of price discovery; (D) considerations of sound risk management practices; and (E) other public interest considerations." 7 U.S.C. § 19(a).[11]

The Commission, in purporting to discharge this responsibility, acknowledged that "significant burdens may arise from the modifications to [Section] 4.5." 77 Fed. Reg. at 11,278; *see*

[11] Members of Congress and certain of the CFTC's own Commissioners have questioned the adequacy of the agency's cost-benefit analyses. *See*, *e.g.*, Letter from Frank D. Lucas, Chairman, Comm. on Agric., and K. Michael Conaway, Chairman, Subcomm. on Gen. Farm Commodities & Risk Mgmt., to A. Roy Lavik, Inspector General, CFTC, at 2 (Mar. 11, 2011) ("[T]he CFTC has taken a vague and minimalist approach to cost-benefit analysis that . . . fails to achieve the objectives of Section 15(a) of the CEA."). In the wake of these criticisms, the CFTC recently agreed that the White House's Office of Information and Regulatory Affairs will provide "technical assistance" with cost-benefit analyses for future rulemakings. Gary Gensler, Chairman, CFTC, Open Commission Meeting for Consideration of Rules Implementing the Dodd-Frank Act (May 10, 2012), *available at* http://cftc.gov/PressRoom/SpeechesTestimony/genslerstatement051012.

also id. at 11,276 ("The Commission has determined that these amendments will create additional compliance costs . . . ."). Commenters agreed with this assessment and identified broad-ranging costs from the proposed regulation, including to reconcile and satisfy disparate regulatory requirements; upgrade systems to produce additional reports; hire additional compliance professionals; satisfy additional registration requirements; prepare and distribute required disclosure documents; and establish controls necessary to monitor and assure ongoing compliance with trading restrictions. *See* SIFMA Comment, at 20-21; ICI Comment, at 11-12. Commenters also pointed to inconsistencies between CFTC and SEC regulations, explaining that it would not be possible to comply with both. *See*, *e.g.*, ICI Comment App. A. For instance, CFTC regulations affirmatively require disclosure of "a significant amount of performance data" that the SEC prohibits as potentially misleading to investors. *Id.* at iii. In public comments after the Rule was adopted, the CFTC Chairman said the Commission "ought to be able to take the forms from the [SEC]"[12] to satisfy its informational needs—but that is not how the Rule functions at all.

Commenters also warned that the dual regulation being instituted by the Rule "may confuse investors" by requiring disclosure of similar information at different times, in different formats, and to different agencies. Janus Capital Comment, at 2. And commenters asserted that the proposal's costs would include loss of the increased liquidity that the 2003 amendment had intended to achieve. *See* CCMC, Comment (Apr. 12, 2011), at 7. This, commenters noted, could lead to "adverse consequences" for the commodity markets and, by extension, "the broader economy." *Id.* These costs would be exacerbated by conflicts between SEC and CFTC regulations: Because "significant portions of the mutual fund industry will be subject to inconsistent

[12] *See* Webcast: Sixth Annual Capital Markets Summit (Mar. 28, 2012) (pt. 2 at 25:18) (Statement of Comm'r Gensler), *available at* http://www.uschamber.com/webcasts/6th-annual-capital-markets-summit ("Capital Markets Webcast").

and often conflicting SEC and CFTC regulations," many such companies may curtail their operations in the commodity markets, leading to "market disruption, less liquidity for remaining market participants and harm to mutual funds' shareholders." Dechert Comment, at 13.

To justify these costs, the Commission briefly cited two purported benefits of its Rule: First, registration would allow the Commission to ensure that registrants meet "minimum standards of fitness and competency." 77 Fed. Reg. at 11,254. And, second, registration would provide "a clear means of addressing wrongful conduct," because the Commission "has clear authority to take punitive and/or remedial action against registered entities." *Id.* The Commission did not elaborate on these assertions in any way, and did not seek to determine whether these benefits are already provided by SEC and FINRA regulation. Nor did the Commission identify any wrongful conduct involving investment companies, or any reason to believe that the SEC and FINRA would not address such conduct if it did occur.

Commenters objected that the Commission's cost-benefit analysis failed to "acknowledge the many protections shareholders currently benefit from under the [ICA] and other federal securities laws." ICI Comment, at 3. Given those protections, the Commission's amendment of Section 4.5 would "impose significant costs on registered investment companies . . . without providing any clear benefits to market participants." SIFMA Comment, at 3. The Commission, however, did not attempt to assess the extent to which the objectives of its Rule were already met by existing SEC regulation, although it acknowledged that "the Commission and the SEC share many of the same regulatory objectives." 77 Fed. Reg. at 11,278.

Commenters also argued that the Commission's cost-benefit analysis was incomplete because the Commission could not possibly know the full costs of its Rule prior to concluding ongoing swap-related rulemakings, including rulemakings further defining the term "swap" and

setting margin levels for swap transactions. *See*, *e.g.*, Institutional Investors, Comment (Apr. 12, 2011), at 5; CCMC Comment, at 5-6. In the final rule release, the Commission responded that the compliance date for the regulation would "provide entities with sufficient time to assess the impact of such rules on their portfolios" after those matters were clarified by subsequent rule-makings. 77 Fed. Reg. at 11,258. This statement was not responsive to the question of how the Commission could assess the costs of the Rule, as required by the CEA, before adoption of the swaps rule and other related rules. The Commission also admitted that it lacked the data necessary to "evaluate the difference in market impact at various threshold levels." *Id.* at 11,278.

The Commission agreed with commenters that overlapping CFTC and SEC regulation would subject investment companies and their advisers to inconsistent obligations with respect to, among other things, disclosure, reporting, and recordkeeping. *See* 77 Fed. Reg. at 11,272; *see also* Invesco Comment, at 5-7; SIFMA Comment, at 13-16. The Commission therefore "acknowledge[d] that there are certain provisions of its compliance regime that conflict with that of the SEC and that it would not be possible to comply with both." 77 Fed. Reg. at 11,272. Instead of addressing these concerns in the instant rulemaking, the Commission simply announced that, "concurrently with the issuance of this rule, the Commission plans to issue a notice of proposed rulemaking detailing its proposed modifications . . . to harmonize the compliance obligations that apply to dually registered investment companies." *Id.* at 11,255.

The Commission acknowledged that splitting up its rulemaking in that fashion affected its ability to assess the costs associated with its Rule: Because it did not know what burdens it was imposing, the Commission declined to discharge its statutory duty under the Paperwork Reduction Act ("PRA") to "estimate . . . the burden that shall result from the collection of information," 44 U.S.C. § 3507(a)(1)(D)(ii)(V), a requirement that applies to these amendments be-

cause they will require filing of registration statements and other disclosures by investment companies. It was "excluding [Section] 4.5 compliance from the PRA burden calculation for these final rules," the Commission explained, "and is recalculating the information collection requirements associated with [Section] 4.5 in the proposed harmonization compliance rules." 77 Fed. Reg. at 11,272. The Commission did not explain how it could fully assess the costs and benefits of the Rule if it could not assess its burdens.

The Commission issued a harmonization rule proposal the same day as its final Rule, setting out proposed amendments to its regulations. *See* 77 Fed. Reg. 11,345 (Feb. 24, 2012). The proposed harmonization rule confirms that significant concerns remain with the redundant and conflicting burdens the Rule under review here will impose on investment companies and their advisers. Commissioner Sommers objected that "[t]he proposed [harmonization] rules, if finalized in their current form, would not achieve true harmonization." *Id.* at 11,352. And commenters on that proposal pointed out significant conflicts left unaddressed. *See*, *e.g.*, ICI, Comment (Apr. 24, 2012) ("ICI Harmonization Comment"), at 3. For instance, in response to the conflict between SEC and CFTC regulations governing past performance data, *see supra* at 14, the Commission stated that investment companies could seek no-action letters from the SEC "if necessary and appropriate." 77 Fed. Reg. at 11,347 n.26. Commenters objected that "[t]his statement does not reflect a harmonized approach to regulation but merely defers the resolution of a known problem to another day." ICI Harmonization Comment, at 22. Commenters pointed out similar conflicts also left unresolved and argued that, without full harmonization, the disclosures required by the CFTC would "essentially nullif[y] the SEC's efforts over the past 30 years to make fund disclosure clear, concise, and therefore more useful to investors." *Id.* at 3.

3. Commissioner Sommers's Dissent

Commissioner Sommers dissented from the Commission's final Rule, including its amendments to Section 4.5. *See* 77 Fed. Reg. at 11,343-44. Congress was "aware of the existing exclusions and exemptions for CPOs when it passed Dodd-Frank," she observed, yet it "did not direct the Commission to narrow their scope." *Id.* at 11,344. Moreover, there is "no evidence to suggest that inadequate regulation of commodity pools was a contributing cause of the [financial] crisis, or that subjecting entities to a dual registration scheme will somehow prevent a similar crisis in the future." *Id.* As for the Commission's cost-benefit analysis, Commissioner Sommers stated: "I do not believe that the benefits articulated within the final rules outweigh the substantial costs to the fund industry," and "[i]t is unlikely, in my view, that the cost-benefit analysis supporting the rules will survive judicial scrutiny if challenged." *Id.*

STANDARD OF REVIEW

Summary judgment is "an appropriate procedure for resolving a challenge to a federal agency's administrative decision" when, as here, "review is based upon the administrative record." *Fund for Animals v. Babbitt*, 903 F. Supp. 96, 105 (D.D.C. 1995) (citing *Richards v. INS*, 554 F.2d 1173, 1177 n.228 (D.C. Cir. 1977)). In an agency challenge, summary judgment "serves as the mechanism for deciding, as a matter of law, whether the agency action is supported by the administrative record and otherwise consistent with the APA." *Air Transp. Ass'n of Am., Inc. v. Nat'l Mediation Bd.*, 719 F. Supp. 2d 26, 32 (D.D.C. 2010) (internal quotation marks omitted). The function of the district court is to "review the administrative record to determine whether the agency's decision was arbitrary and capricious, and whether its findings are based on substantial evidence." *Forsyth Mem'l Hosp., Inc. v. Sebelius*, 639 F.3d 534, 537 (D.C. Cir. 2011).

Agency action is arbitrary and capricious when, among other things, the agency "entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983). The agency's explanation for its decision must be sufficient to enable a court to conclude that the decision "was the product of reasoned decisionmaking," *id.* at 52, and must have "respond[ed] to substantial problems raised by commenters," *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1149 (D.C. Cir. 2011).

An agency's decision may not be affirmed "on a ground other than that relied upon by the agency" in the rule release. *Manin v. Nat'l Transp. Safety Bd.*, 627 F.3d 1239, 1243 (D.C. Cir. 2011). Thus, in this litigation the Commission may not proffer arguments for the Rule that were not relied upon in adopting the Rule below. *SEC v. Chenery Corp.*, 318 U.S. 80, 87-88 (1943).

ARGUMENT

The explanation advanced by the Commission for the Rule comports with neither the APA nor the cost-benefit provision of the CEA. The Commission failed to explain why its regulation was necessary, or how it would yield any conceivable benefit given existing regulation of investment companies and their service providers by the SEC and FINRA. And the Commission failed to meaningfully address its prior, 2003 regulation, which concluded that CFTC regulation was *not* necessary precisely because investment companies are "otherwise regulated" by the SEC. While failing to identify any actual benefit from its regulation, the Commission acknowledged that its Rule would impose "significant" costs. Yet it imposed those costs in a manner that made it impossible to evaluate the full extent of the costs before the Rule's adoption, as required by law. The Commission also failed to provide an adequate explanation for specific aspects of its Rule, or to provide the public a sufficient opportunity to comment.

In all of these respects, the Commission's adoption of the Rule fell far short of the APA's standard of reasoned decisionmaking, as well as the requirement of a meaningful evaluation of costs and benefits imposed by the CEA. The Rule's amendments to Sections 4.5 and 4.27 of the Commission's regulations must, accordingly, be vacated. The APA is unambiguous: A rule "shall" be vacated if inconsistent with the requirements of that Act. 5 U.S.C. § 706(2)(A); *see also NRDC v. EPA*, 489 F.3d 1250, 1262 (D.C. Cir. 2007) (Randolph, J., concurring). Indeed, when an agency has relied on alternative grounds to support a regulatory choice and even one of those grounds is deficient, the practice within this circuit is "ordinarily [to] vacate the [rule] unless [it is] certain that [the agency] would have adopted it even absent the flawed rationale." *Nat'l Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831, 839 (D.C. Cir. 2006).[13]

The Commission's errors infect the heart of its rationale for promulgating the Rule, which will impose significant costs on investment companies and their shareholders. It must be vacated.

I. By Adopting The Rule Without Considering Its Necessity, The Commission Violated Both The Administrative Procedure Act And The Cost-Benefit Provisions Of The Commodity Exchange Act.

The Commission has failed to satisfy the most basic requirement of agency decisionmaking: to identify a problem that justifies its action, and to demonstrate that its Rule provides a logical solution. The Commission explained that its Rule was intended to address increased participation by investment companies in the commodity markets. 77 Fed. Reg. at 11,275. Yet the

[13] The factors that have caused courts to remand without vacatur in certain cases are absent here: (1) The Rule has not gone into effect, at least for previously registered investment companies, *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 179 (D.C. Cir. 2010); (2) the regulatory "egg has [not] been scrambled" and vacatur will maintain "the status quo ante," *Milk Train, Inc. v. Veneman*, 310 F.3d 747, 756 (D.C. Cir. 2002) (internal quotation marks omitted); (3) vacatur will not forfeit funds that the government could not recoup later, *Heartland Reg'l Med. Ctr. v. Sebelius*, 566 F.3d 193, 198 (D.C. Cir. 2009); and (4) public health and safety are not threatened, *NRDC*, 489 F.3d at 1265-67 (Rogers, J., concurring in part and dissenting in part).

Commission failed to explain why such increased participation calls for additional regulation, or why existing SEC regulation is not sufficient. This yawning gap in the Commission's reasoning makes the Rule unsupportable under both the APA and the CEA cost-benefit provision.

In order to "articulate a satisfactory explanation for its action," *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983), an agency must ordinarily explain why its rule is necessary, or, put differently, what problem the rule is meant to address. *See*, *e.g.*, *Nat'l Fuel Gas Supply*, 468 F.3d at 841 (vacating agency action where there was "no evidence of a real problem"). For an agency to promulgate a regulation without identifying a need is the very essence of arbitrary and capricious governmental decisionmaking.

Moreover, the CFTC is required to meet a heightened statutory obligation to conduct a meaningful and thorough assessment of costs and benefits. Section 15(a) of the CEA provides that the Commission must "consider the costs and benefits" of its proposed rules, which "shall be evaluated" based on "protection of market participants and the public," "efficiency, competitiveness, and financial integrity of futures markets," "price discovery," and "sound risk management practices," among other things. 7 U.S.C. § 19(a). This directive is similar to the SEC's obligation to "consider . . . whether [its rules] will promote efficiency, competition, and capital formation." 15 U.S.C. § 78c(f); *see also id.* §§ 77b(b), 80a-2(c). The SEC's failure to fulfill that requirement has resulted in a series of recent decisions by the D.C. Circuit invalidating SEC rules. *See 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). And the obligation placed on the CFTC is arguably even more stringent. The SEC is directed to "consider" costs and benefits, whereas the CFTC must both "consider" and "*evaluate*," which is "to determine or set the value of" or to "determine the significance, worth, or condition

of" a thing, usually "by careful appraisal and study." *Merriam-Webster Collegiate Dictionary* 401 (1993).

When evaluating the benefits of a rule, a necessary first step is to identify some problem that is being addressed. Thus, for instance, the D.C. Circuit in *Business Roundtable* vacated an SEC rule directed to investment companies because the agency "failed adequately to address whether the regulatory requirements of the ICA reduce the need for, and hence the benefit to be had from," further regulation. 647 F.3d at 1154. And in *American Equity Life Insurance Company*, the D.C. Circuit vacated a rule because the SEC failed to examine existing regulations to "determine whether, under the existing regime, sufficient protections existed." 613 F.3d at 179. In both cases, the agency failed to explain why, given rules already on the books, there was any need for added regulation. Requiring such an explanation makes good sense: If a rule is unnecessary, it is difficult to say how the rule can yield any benefit, or how its benefits can possibly justify its costs. Yet precisely this error pervades the rulemaking at issue here.

A. The Commission Failed To Show That Existing Regulations Are Inadequate.

The Rule layers CFTC and NFA regulation on top of existing regulation by the SEC and FINRA, thus subjecting investment companies to four separate regulatory masters. The Commission itself acknowledged that these separate regulatory regimes serve the same ultimate goals, stating that "the Commission and the SEC share many of the same regulatory objectives." 77 Fed. Reg. at 11,278. But the Commission failed to compare the protections of these regulatory regimes or to demonstrate that an added layer of regulation was necessary.

Indeed, the portions of the final rule release discussing Section 4.5 do not cite a *single* SEC statute or regulation, much less assess whether existing regulations would satisfy the regulatory aims of the CFTC. The final rule release does not identify which SEC and FINRA regulations affect investment companies and their service providers, nor does it determine which CFTC

and NFA regulations overlap with those existing requirements. In fact, CFTC and NFA regulation of CPOs covers many areas already covered by the SEC and FINRA: Both regimes require registration, reporting, and disclosure; both impose recordkeeping obligations; both require protection of investor assets; both impose statutory anti-fraud provisions; both impose advertising restrictions; and both require qualifications testing of the persons who sell investment company shares or commodity pool interests. The Commission made no effort to determine the extent to which these overlapping regulations pursue the same objectives.

In addition to failing to identify the similarities between the two regimes, the Commission failed to identify and assess the significance of the differences. Most obviously, despite acknowledging that "there are certain provisions of its compliance regime that conflict with that of the SEC," 77 Fed. Reg. at 11,272, the Commission failed to determine the extent of those conflicts. *See infra* at 37-38. The Commission also failed to identify and assess the significance of the ways in which existing regulation of investment companies goes well beyond CFTC regulation of CPOs. These include independent board oversight; oversight by a chief compliance officer; and firm-specific compliance policies. *See supra* at 5. They also include limitations on transactions, including commodity interest transactions, that create risk through leverage. *Id.* Because the Commission imposes no comparable limitations on CPOs, investment companies and their service providers are *already* more strictly regulated than other CPOs. The Commission nowhere assessed the implications of that fact.

Nor did the Commission point to any wrongdoing in the operation of investment companies that has gone unaddressed under the existing regulatory regime. Indeed, the Commission in its final rule release did not identify *any* wrongdoing involving investment companies. The

Commission objected that investment companies were "offering services substantially identical to" registered CPOs, 77 Fed. Reg. at 11,255, but that in itself is not inherently a problem.

The Commission also made no attempt to demonstrate that investment companies' participation in the commodity markets was sufficiently widespread to justify its Rule. The Commission cited an NFA petition for rulemaking that identified "three entities" marketed to investors "as commodity futures investments." NFA, Petition for Rulemaking, at 3-4 (Aug. 18, 2010). But the Commission cited no reason to think that substantial numbers of firms were engaged in similar activity. It did not provide any estimate of the extent to which participation in the commodity markets by investment companies had increased, and it did not assess the extent to which such participation served risk-management functions.

This analytical failure by the Commission was arbitrary and capricious. An essential step in any rulemaking is to identify the baseline of benefits already provided under the status quo. Thus, for example, the White House's Office of Information and Regulatory Affairs recently explained that agencies should give "[c]areful consideration, in the analysis of costs and benefits, [to] the relationship between new regulations and regulations that are already in effect." Memorandum, Cumulative Effects of Regulations (Mar. 20, 2012), at 2; *see also* Exec. Order No. 13,579, 76 Fed. Reg. 41,587 (July 14, 2011). Without such analysis, an agency cannot know if there is any need for its regulation, or if instead it is striving to fill a void that has already been filled. A decision to eschew this assessment violates the basic requirements of reasoned agency decisionmaking. *See*, *e.g.*, *Nat'l Fuel Gas Supply*, 468 F.3d at 841; *see also Bus. Roundtable*, 647 F.3d at 1155-56 (vacating rule because agency did "not adequately address the probability the rule will be of no net benefit as applied to investment companies").

This gap in the Commission's analysis also constituted a failure to respond to significant comments in the record. Commenters discussed the overlap between SEC and CFTC regulations in great detail; they cited existing SEC regulations and specifically compared those regulations to CFTC regulation of CPOs. *See*, *e.g.*, SIFMA Comment (Oct. 18, 2010), at 2-4 & nn.4, 5, 6. On this basis, commenters concluded that the Rule "will not result in increased consumer protections, but will instead subject registered investment companies to duplicative, and in many cases inconsistent, regulatory requirements." *Id.* at 2; *see also* ICI Comment App. A. They deemed the imposition of overlapping regulation "unnecessary," Janus Capital Management, Comment (Apr. 12, 2011), at 2, "duplicative," ICI Comment, at 12, and "redundant," Vanguard Comment, at 2, not to mention "burdensome and costly, as well as potentially misleading to investors," ICI Comment, at 28. Because this conclusion, if true, "would require a change in the proposed rule," the Commission was required to respond. *La. Fed. Land Bank Ass'n v. Farm Credit Admin.*, 336 F.3d 1075, 1080 (D.C. Cir. 2003) (internal quotation marks and alterations omitted). It failed to do so.

Finally, the Commission's failure to compare its own regulations to those of the SEC rendered inadequate its analysis under the cost-benefit provision of the CEA. In this regard, the case bears a striking resemblance to *American Equity*, where the D.C. Circuit vacated an SEC regulation asserting jurisdiction over fixed indexed annuities. 613 F.3d at 179. Commenters in that case presented substantial evidence that state law already regulated many aspects of fixed indexed annuities, and that SEC regulation was therefore unnecessary. *See* 74 Fed. Reg. 3,138, 3,147-49 (Jan. 16, 2009). The agency failed to assess the effectiveness of the current state regime, and in its cost-benefit analysis reached conclusions that could not be supported without such an assessment: It concluded that the rule would advance informed decisionmaking, but this

analysis was "incomplete because it fails to determine whether, under the existing regime, sufficient protections existed to enable investors to make informed investment decisions," 613 F.3d at 179; and it concluded that the rule would promote competition but failed to "make any finding on the existing level of competition in the marketplace under the state law regime," *id.* at 178. The D.C. Circuit found that the agency had not satisfied its statutory obligations to "assess the baseline" of existing state-law regulation and that "[t]he SEC's failure to analyze the efficiency of the existing state law regime renders arbitrary and capricious the SEC's judgment that applying federal securities law would increase efficiency." *Id.* at 179.

In this case, the Commission likewise failed to support its conclusions with respect to the specific factors enumerated in Section 15(a). The Commission determined that its Rule would protect market participants and the public "by requiring certain parties previously excluded or exempt from registration to be held to the same standards as registered operators and advisors," and by providing "the benefits of transparency." 77 Fed. Reg. at 11,280. Yet this conclusion is baseless without an assessment of the extent to which existing regulation *already* protects investors and *already* provides the benefits of transparency. Similarly, the Commission determined that the Rule will advance the efficiency, competitiveness, and financial integrity of the futures markets because it "will result in the registration of more CPOs," which purportedly "will enable the Commission to better oversee their activities in the derivatives markets, thereby protecting the integrity of the markets." *Id.* Again, this conclusion is spurious without an assessment of whether additional oversight is necessary given the existing regulatory regime. The Commission's analysis of these matters in the rule release is "incomplete because it fails to determine whether, under the existing regime, sufficient protections existed." *Am. Equity*, 613 F.3d at 179.

The Commission's cost-benefit analysis in this case is very similar to *Business Roundtable*, another case recently decided by the D.C. Circuit. 647 F.3d at 1154-56. There, the court considered an SEC regulation that applied broadly to public companies, including investment companies. *Id.* at 1146. Investment companies challenged the application of the rule to them, arguing that the SEC "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. *Id.* at 1154. The D.C. Circuit agreed. The agency, the court found, had failed to explain why certain asserted benefits of the rule were not already provided by existing regulation of investment companies; for example, although the rule was intended to give shareholders greater control over the board, the agency had failed to "consider that the ICA already requires shareholder approval of advisory contracts." *Id.* at 1154-55.

As in *Business Roundtable*, the Commission in this case "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. 647 F.3d at 1154. The Commission's analysis of costs and benefits relied on two purported benefits, yet it failed to determine whether either was already provided by existing regulation: First, the Commission stated that registration would allow it to ensure that registrants meet "minimum standards of fitness and competency," 77 Fed. Reg. at 11,277, but it failed to show that existing regulations fail to achieve this goal. Indeed, existing CFTC regulations implicitly recognize that SEC and FINRA standards are sufficient: the regulations exempt from qualifications testing by the NFA a great many persons who are associated with broker-dealers that distribute investment company shares and already are subject to qualifications testing by FINRA. *See* 17 C.F.R. § 3.12(h)(1)(ii).

Second, the Commission stated that registration would provide "a direct means to address wrongful conduct by participants in the derivatives markets" because the Commission "has direct authority to take punitive and/or remedial action against registered entities." 77 Fed. Reg. at 11,277. But the Commission did not attempt to determine whether the SEC and FINRA already have authority to take "punitive and/or remedial action" against investment companies, or whether oversight by an additional agency and self-regulatory organization would afford any benefit to investors. In fact, the SEC has ample authority to investigate, subpoena, and bring enforcement actions against investment companies and their advisers; FINRA has additional authority to discipline misconduct by broker-dealers that distribute investment company shares through, among other things, suspension and disbarment. *See supra* at 4, 6. The Commission did not address these existing regulations, or the "probability the rule will be of no net benefit as applied to investment companies" because of the regulations. *Bus. Roundtable*, 647 F.3d at 1155. Nor, again, did the Commission give any reason to believe that there currently is "wrongful conduct" involving investment companies that it must address.

B. The Agency Sought To Justify Its Rule With Conclusory And Circular Assertions.

Rather than undertake a proper analysis, the Commission sought to justify the Rule with a series of empty platitudes that do not pass muster under the APA.

1. The Commission asserted that it "believes that the benefits provided by these rules are supplementary to, and not duplicative or redundant of, benefits provided by the federal securities laws." 77 Fed. Reg. at 11,276. The Commission's "*ipse dixit* conclusion, coupled with its failure to respond to contrary arguments" by commenters based on citation and discussion of existing regulation "epitomizes arbitrary and capricious decisionmaking." *Ill. Pub. Telecomms. Ass'n v. FCC*, 117 F.3d 555, 564 (D.C. Cir. 1997) (per curiam).

2. The Commission cited its statutory authority to regulate, asserting that registration would be consistent with its "Congressional mandate" to administer the CEA "to foster open, competitive, and financially sound commodity and derivatives markets." 77 Fed. Reg. at 11,278. The D.C. Circuit rejected just such an argument in *American Equity*. There, the SEC argued that State regulation "could not substitute" for regulation by the SEC, because Congress had given the SEC authority to regulate securities such as the annuity products at issue in that case. 613 F.3d at 178 (internal quotation marks omitted). The D.C. Circuit concluded, however, that the agency had an "obligation to consider the economic implications" of its rule, and that the agency's reliance on its statutory authority to address that question was "misplaced." *Id.*

The CFTC's empty appeal to its authority is no more persuasive in this case. The Commission's citation to the CEA demonstrates only that it has the power to regulate; it does not excuse the Commission from the obligation to justify its regulation. Indeed, the CEA itself, in its cost-benefit provision, specifically contemplates that the Commission will temper the exercise of its regulatory authority with a consideration of whether the Rule provides sufficient benefits to justify its costs. The CEA also expressly grants the Commission authority to exclude entities from the definition of a CPO, an authority that the Commission has exercised to exempt a wide variety of otherwise-regulated entities from CPO registration. The Commission was under an obligation to explain in a reasoned fashion how its action was "consistent with" the grant of exemptive authority, as well as how it was "consistent with" the cost-benefit provision of the CEA. The Commission failed to do so.

3. The Commission claimed that its "programs are structured and its resources deployed to meet the needs of the markets it regulates." 77 Fed. Reg. at 11,278. Such "conclusory statements are not sufficient" to satisfy the APA. *Am. Mining Cong. v. EPA*, 907 F.2d 1179, 1189

(D.C. Cir. 1990). Indeed, even assuming the Commission is correct about the value of its regulation, that fact is irrelevant because the Commission made no attempt to demonstrate that the SEC's programs and regulations are *not* adequate to advance the Commission's regulatory objectives with respect to investment companies. Absent such a showing, the fact that the Commission's resources are adequate, standing alone, fails to establish that investors would derive any benefit whatsoever from additional, overlapping, and redundant regulation.

4. The Commission stated that "the Dodd-Frank Act has given the Commission a more robust mandate to manage systemic risk" and that registration would provide "reliable information" to "execute this mandate." 77 Fed. Reg. at 11,275. In fact, however, the Dodd-Frank Act amended the CEA in numerous material respects, but made no change to the Commission's authority to exclude investment companies from its regulation of CPOs. Nor has the Commission suggested that investment companies or their investment in commodity interests pose any risk to the financial system generally, or contributed to the financial crisis that led to the passage of Dodd-Frank. In short, Dodd-Frank called for additional regulations of specific matters by the CFTC; it is not a carte blanche justification for whatever new rules the CFTC desires.

The Commission likewise did not explain why its Rule was necessary in order to obtain "reliable information." Commenters suggested that "reliable information" could be obtained by other means—such as information-sharing with the SEC—that would not require subjecting investment companies and their advisers to the full panoply of regulations governing CPOs. *See, e.g.*, Fidelity Comment, at 2; Tr. of Roundtable to Discuss Proposed Changes to Registration and Compliance Regime for Commodity Pool Operators and Commodity Trading Advisors (Jul. 6, 2011) ("Roundtable Transcript"), at 18-19, 37-38. The Commission did not determine that the information provided on the SEC's forms was inadequate. Indeed, the Chairman of the CFTC

recently said that forms filed by investment companies with the SEC would be more than sufficient to provide the information that the CFTC needs to discharge its responsibilities.[14] The Commission's desire for information thus provides no justification for requiring an entirely different set of forms, or for subjecting investment companies to a variety of *other* regulations (imposed both by the CFTC and the NFA) that have nothing at all to do with information collection.

5. The Commission suggested that its regulation was needed to ensure uniform treatment of regulated entities. *See* 77 Fed. Reg. at 11,255. That was wholly irrational because the Rule does not, in fact, ensure uniform treatment. To the contrary, the Rule breaks with a nearly-30 year history of uniform treatment of "otherwise regulated" entities under Section 4.5 by subjecting *only* investment companies to trading and marketing thresholds. Numerous "otherwise regulated" entities—including banks, trust companies, pension plans, and insurance companies—continue to be exempt from registration under Section 4.5 without regard to trading or marketing thresholds, even though the Commission articulated no reasoned explanation for treating investment companies differently. Moreover, among registered CPOs, only investment companies and their advisers will be subject to burdensome and overlapping dual regulation by both the SEC and the CFTC. Other registered CPOs are either regulated only by the CFTC or, to the extent they are subject to any SEC regulation, are regulated under the '33 Act, not the more demanding requirements of the ICA. By singling out investment companies for dual regulation, the Rule heightens, rather than ameliorates, differences in regulatory treatment. The Commission's suggestion to the contrary is patently incorrect.

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[14] *See* Capital Markets Webcast ("Once they're registered we ought to be able to take the forms from the other agency."). Chairman Gensler's remarks in fact suggested that he believes this is how the Rule will operate. He stated: "We said, if you do enough business in futures and swaps, yes, you need to register with the CFTC, but we are more than happy to use the forms that you use over at the SEC. . . . They would be dually registered, but we take all the same documents." *Id.* This, however, is not at all what the Rule will do.

II. The Commission Arbitrarily Reversed Its Prior Rulemaking With No Meaningful Justification.

The Commission disregarded another basic requirement of the APA: "Reasoned decision making . . . necessarily requires the agency to acknowledge and provide an adequate explanation for its departure from established precedent." *Dillmon v. NTSB*, 588 F.3d 1085, 1089-90 (D.C. Cir. 2009); *see also FCC v. Fox Television Stations, Inc.*, 129 S. Ct. 1800, 1811 (2009) (when an agency changes course from a prior policy, it must provide a "reasoned explanation . . . for disregarding facts and circumstances that underlay . . . the prior policy"). An agency cannot simply disregard the reasoning or factual conclusions that underlay its prior action; to the contrary, "[i]t would be arbitrary or capricious to ignore such matters." 129 S.Ct. at 1811. Yet that is precisely what the Commission did here: It abruptly changed course without a meaningful explanation of the grounds for reversal and failed even to mention—much less provide an explanation for disregarding—its analysis in 2003 of the costs and benefits of eliminating the trading and marketing thresholds.

The Commission's final rule release seeks to justify the Rule on the ground that investment companies are increasingly participating in the commodity markets, 77 Fed. Reg. at 11,275, but this was *the very result the Commission sought to achieve* in its 2003 rulemaking. In 2003, the Commission concluded that eliminating the trading and marketing thresholds would "encourage and facilitate participation in the commodity interest markets" and provide the "benefit to all market participants of increased liquidity." 2003 Proposing Release at 12,625; *see also* 2003 Adopting Release at 47,230 (concluding that eliminating trading and marketing thresholds would "benefit efficiency and competition by removing barriers to participation in the commodity interest markets, resulting in greater liquidity and market efficiency"). This abrupt change of course required explanation by the Commission.

And yet the Commission provided none. Its final rule release does not even mention its 2003 conclusion that eliminating the trading and marketing thresholds would promote liquidity and market efficiency. Nor did the Commission explain why it had abandoned its prior conclusion that the "otherwise regulated" nature of investment companies justified excluding them from its regulation of CPOs. 2003 Proposing Release at 12,625; *see also* 2003 Adopting Release at 47,230 (explaining that there would be "no decrease in the protection of market participants and the public" because "the amendments relax existing requirements . . . in order to be consistent with existing requirements under the federal securities laws and the SEC's rules"). And the Commission provided no explanation why it was departing from a nearly 30-year history of uniform treatment for "otherwise regulated" entities under Section 4.5 by re-imposing trading and marketing thresholds *only* for registered investment companies. This silence cannot be squared with the APA's requirement of reasoned decisionmaking.[15]

Similarly, the Commission failed to explain why it was departing from its prior assessment of the costs and benefits of eliminating the trading and marketing thresholds. In 2003, the Commission explained that eliminating the thresholds would yield significant benefits, including increased liquidity and efficiency, and better risk management. *See supra* at 8-9. At the same

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

time, the "otherwise regulated" nature of investment companies meant there would be no countervailing cost. *Id.* These conclusions from 2003 have obvious and direct relevance to the costs and benefits of the Rule adopted here. And yet the Commission did not even mention the fact that it had previously assessed the costs and benefits associated with registration thresholds, much less explain why it no longer found that analysis convincing. Because "change must be reached through reasoned decision," *Wheaton Van Lines, Inc. v. Interstate Commerce Comm'n*, 671 F.2d 520, 527 (D.C. Cir. 1982), the Commission's failure to address its prior conclusions was arbitrary and capricious and violated the APA.

III. The Commission Imposed Significant And Unnecessary Costs While Making It Impossible To Fully Determine Those Costs As Required By Law.

As the D.C. Circuit has repeatedly emphasized, a statutory requirement to consider costs and benefits akin to that imposed by Section 15(a) of the CEA requires that an agency "apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation." *Chamber of Commerce*, 412 F.3d at 144; *see also Bus. Roundtable*, 647 F.3d at 1148; *Am. Equity*, 613 F.3d at 177. The agency must "fram[e] the costs and benefits of the rule," "adequately . . . quantify . . . costs or . . . explain why those costs could not be quantified," and "support its predictive judgments." *Bus. Roundtable*, 647 F.3d at 1148-49. And the agency's fulfillment of these responsibilities must, as always, satisfy the APA's overarching requirement of reasoned decisionmaking. *See id.* at 1148. The Commission failed to meet that obligation in this case because it promulgated the Rule in a manner that made it impossible to evaluate the full extent of those costs and purported benefits, as required by law.

The Commission acknowledged that "significant burdens may arise from the modifications to [Section] 4.5." 77 Fed. Reg. at 11,278. These include compliance costs for investment companies and their advisers, such as to reconcile and satisfy disparate regulatory requirements;

upgrade systems to produce additional reports; hire additional compliance personnel; satisfy additional registration requirements; prepare and distribute required disclosure documents; and establish controls necessary to monitor and assure compliance with trading restrictions. Even investment companies that may not trigger the registration thresholds will be required to expend significant time and resources monitoring compliance with the regulations, lest their trading or marketing activities trigger registration.

The costs of the Rule will also include negative effects on investors in investment companies. Absent meaningful harmonization, investors may be confused by overlapping regulation, as firms make similar but distinct disclosures in different times and in different formats. And—just as the Commission concluded in 2003 that eliminating the trading and marketing thresholds would improve liquidity, efficiency, and risk-management—so re-imposing those thresholds must be expected to have the opposite effect. At least some investment companies will restrict their activities to avoid triggering the registration thresholds, thereby "restricting investors' access to these important markets and potentially disrupting markets as [investment companies] seek to exit their existing commodities positions." Invesco Comment, at 2.

Despite these significant adverse consequences for markets and investors, the Commission promulgated the Rule in a manner that made it impossible to properly determine the extent of the costs it was imposing.

1. The Commission deprived itself of the ability to assess the costs of its Rule, first, by failing to obtain relevant market data. The Commission frankly acknowledged that "current data and information does not allow the Commission to evaluate the difference in market impact at various threshold levels." 77 Fed. Reg. at 11,278. Commenters urged the Commission to undertake the study necessary to obtain the missing data. *See* Vanguard Comment, at 8; Invesco

Comment, at 3. And commenters identified ways that the Commission might go about obtaining the data that it needed. *See*, *e.g.*, ICI, Comment (July 28, 2011), at 7. At a roundtable held in connection with the rulemaking, where the issue was discussed at considerable length, the Assistant Director of the Commission's Division of Clearing and Intermediary Oversight responded as follows: "Even though my training . . . would say you get the data first, I'm not seeing it in this current political and budgetary environment." Roundtable Transcript, at 84 (statement of Mr. Walek).

2. The Commission also made it impossible to meaningfully assess the costs of its Rule by including swaps within its proposed trading threshold when key regulations regarding swaps—including the very definition of the term—have yet to be finalized. The Commission has not adopted a final definition of the term swap or established margin requirements for uncleared swap transactions, and the Department of Treasury has not issued a final determination on whether it will exempt certain foreign exchange swaps and forwards from the definition of "swap." Because the trading threshold requires registration where the "initial margin and premiums required to establish" positions in "swaps" exceeds five percent, the ultimate determination of both those factors has the potential to significantly affect the number of firms required to register under the trading threshold. Without knowing how many firms will be required to register, it is impossible to meaningfully assess the costs associated with the Rule. The CFTC's determination to regulate in a manner that created this uncertainty was arbitrary and capricious.

When commenters pointed out this concern, the Commission responded that the compliance date for the Rule would "provide entities with sufficient time to assess the impact of such rules on their portfolios" after these other swap-related rulemakings were concluded. 77 Fed.

Reg. at 11,258. But post-hoc assessment of costs and benefits by regulated entities cannot substitute for the pre-enactment evaluation required by law to be performed by the agency itself.

3. Finally, the Commission deprived itself of the ability to evaluate the costs of its Rule by adopting a Rule that it admitted would create conflicts and overlap with SEC regulations, and by failing to determine, prior to finalization of the Rule, whether and how those problems could be resolved. The Commission agreed with commenters that "there are certain provisions of its compliance regime that conflict with that of the SEC and that it would not be possible to comply with both," 77 Fed. Reg. at 11,272, but it determined to address those conflicts in a separate "harmonization" rulemaking that has yet to be concluded. This decision led the Commission to determine in the final rule release for *this* rulemaking that it could not calculate the Rule's burdens under the PRA. But if it was too early to determine the burdens associated with the Rule, it follows that it was also too early to calculate the costs.

The Commission's regulate-first and harmonize-later approach creates a substantial possibility that investment companies and their advisers will be subject to conflicting regulations by the SEC and the CFTC. After all, there is no guarantee that the Commission's harmonization efforts will be successful. To the contrary, in the notice of proposed rulemaking for the harmonization rule, Commissioner Sommers warned that "[t]he proposed rules, if finalized in their current form, would not achieve true harmonization." 77 Fed. Reg. 11,345, 11,352 (Feb. 24, 2012). And commenters on the harmonization rulemaking have identified numerous conflicts left unaddressed by the harmonization proposal. *See* ICI Harmonization Comment, at 21-22; *see also id.* at 22-46. If harmonization is *not* achieved, the compliance burdens of investment companies and their advisers will be magnified greatly, as they will bear the additional burden of striving to reconcile irreconcilable obligations. By deferring consideration of these issues, the Commission

"failed to deal with the concern that [its regulations of CPOs] will impose greater costs upon investment companies by disrupting" the regulatory regime imposed by the SEC. *Bus. Roundtable*, 647 F.3d at 1155.

The Commission itself implicitly acknowledged the arbitrary and capricious nature of this approach when it declined to undertake the burden analysis required by the PRA. When an agency promulgates a rule, the PRA requires it to publish an estimate of the burdens associated with the rule in the Federal Register, for review by the Office of Management and Budget. *See* 44 U.S.C. § 3507. As the House Report accompanying the PRA explained, Congress instituted this requirement because excessive collection of information by the government can impose "significant costs on the economy." H.R. Rep. No. 104-37, at 5 (1995); *see also* 44 U.S.C. § 3501(1). The PRA thus specifically addresses one component of the cost-benefit analysis required by the CEA—the burdens associated with the collection of government information.

The Commission announced that it would conduct the analysis required by the PRA *after* the harmonization rulemaking is complete. 77 Fed. Reg. at 11,272. Yet the Commission nowhere explained how it could calculate the costs of the Rule, as required by Section 15(a) of the CEA, if it could not satisfy its obligation under the PRA to calculate the burdens. One important component of the cost imposed by a rule is, after all, the extent of the paperwork burden it will impose; indeed, the fact that Congress has devoted an entire statute to the reduction of paperwork burdens emphasizes the seriousness of the issue. By postponing this aspect of its analysis until *after* the completion of a separate rulemaking, the Commission "failed to consider an important aspect of the problem." *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43.

In sum, the Commission failed to take readily available steps to determine either the costs or the benefits of its Rule. The Commission adopted the Rule in a manner that deprived it of the

ability to meaningfully determine the Rule's costs, a fact that the Commission implicitly acknowledged when it declined to assess the burdens the Rule would impose. At the same time, it failed to determine whether its Rule would provide any benefits at all in the context of existing regulations. *See Public Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209, 1222 (D.C. Cir. 2004) (criticizing "one-sided and passive regulatory approach" to cost-benefit analysis that failed to "accoun[t] for benefits as well as costs"). It thus conducted a cost benefit "analysis" that analyzed neither costs nor benefits. That is no analysis at all.

IV. The Commission Failed To Provide Reasoned Justification For Significant Aspects Of Its Rule.

The Commission also failed to provide a reasoned explanation to justify specific aspects of its rulemaking. The Commission imposed new filing obligations on investment companies and advisers without considering whether those obligations were necessary. And the Commission failed to provide any reasoned explanation for its inclusion of swaps within the registration thresholds, its restrictive definition of bona fide hedging, and its determination to set the non-bona-fide hedging trading threshold at five percent.

1. ***Requirement That Investment Company Advisers File Form CPO-PQR.*** At the same time that it narrowed the Section 4.5 exclusion for investment companies, the Commission arbitrarily and capriciously multiplied the regulatory burden imposed on *all* registered CPOs by adopting new Section 4.27, which will require CPOs to file a report called Form CPO-PQR. 77 Fed. Reg. at 11,285-86, 11,295-96. This form will require disclosures regarding management of the investment pool, identities of associated persons, past performance, and pool assets and liabilities. Some entities will be required to file the report with the Commission quarterly. *Id.*

Commenters explained that, in the context of investment companies, these extensive disclosures would be wholly unnecessary. Investment companies already file quarterly, semi-

annual and annual regulatory reports with the SEC that provide detailed information generally comparable to that requested by Form CPO-PQR. *See* ICI Comment, at 33 and App. A. Yet the Commission nowhere determined what information already was disclosed, and nowhere compared the content of those disclosures to Form CPO-PQR. And, to the extent that any information was *not* already disclosed to the SEC, the Commission failed to explain why it could not limit the reporting requirement for investment companies to that information.

The Commission sought to justify Form CPO-PQR on the ground that "[t]he sources of risk delineated in the Dodd-Frank Act with respect to private funds are also presented by commodity pools," and Form CPO-PQR would "provide the Commission with similar information to address these risks." 77 Fed. Reg. at 11,253. But the Commission failed to evaluate whether investment companies present such risks. *See* Seward & Kissel Comment (Apr. 12, 2011), at 7.

2. *Inclusion Of Swaps Within The Registration Thresholds.* The Commission also gave an illogical and inadequate explanation for its decision to include swaps within the registration thresholds.

In the Dodd-Frank Act, Congress expanded the Commission's jurisdiction to include swaps and expanded the statutory definition of a CPO to include entities that trade in swaps. *See* Pub. L. No. 111-203, § 721, 124 Stat. 1376, 1659-60 (2010). Commenters urged, however, that the Commission was not required to include swaps in the calculation of whether an investment company met the Rule's registration thresholds, and that doing so was unnecessary and premature. Including swaps was unnecessary because the "Commission is currently engaged in swap-related rulemaking" that will "establish an extensive reporting framework with respect to swaps" and "adequately addres[s] the CFTC's concerns with respect to increased transparency and accountability." SIFMA Comment, at 6; *see also* Fidelity Comment, at 4. And it was premature

because development of that regulatory regime was in flux—indeed, the term "swap" has not been fully defined—and the effect of the registration threshold could vary greatly depending on the final content of those regulations. *See* Invesco Comment, at 5; Janus Comment, at 2. Further, even if the Commission were to include *some* trading in swaps within the registration thresholds, the Commission failed to justify "broad inclusion of all non-security based swaps": investment companies use such instruments for a broad variety of purposes, many of which have nothing to do with gaining exposure to the commodities markets. ICI Comment, at 18.[16]

The Commission's response was nonsensical. Observing that Dodd-Frank amended the statutory definition of a CPO to include trading in swaps, the Commission stated, "if [it] were to adopt the trading threshold and only include futures and options as the basis for calculating compliance with the threshold, the swaps activities of the registered investment companies would still trigger the registration requirement notwithstanding the exclusion of swaps from the calculus." 77 Fed. Reg. at 11,258. Thus, "[i]f swaps were excluded, any swaps activities undertaken by a registered investment company would result in that entity being required to register." *Id.* This reasoning misreads amended Section 4.5, which requires registration only if an investment company triggers the trading or marketing thresholds, so that excluding swaps from the thresholds would result in the exclusion of more entities, not fewer. And the reasoning proceeds on the bizarre assumption that the Commission could not fashion language that would exclude swaps from the determination of whether an investment company met the definition of a CPO. Of course, the Commission's drafting skills are not so limited. The Commission arbitrarily and capriciously failed even to acknowledge this obvious alternative, much less explain why it chose

[16] For instance, the registration thresholds sweep in interest rate swaps, which may be used "to adjust the interest rate and yield curve exposures of the investment company or to replicate a broadly diversified fixed income strategy." ICI Comment, at 18.

not to pursue it. *See Chamber of Commerce*, 412 F.3d at 145 (because an "alternative was neither frivolous nor out of bounds," the agency "had an obligation to consider it").

3. *Definition Of Bona Fide Hedging.* The Commission also arbitrarily adopted a narrow definition of bona fide hedging. Under the Rule, bona fide hedging transactions are excluded from the calculation of whether an investment company's activities trigger the trading threshold. *See* 77 Fed. Reg. at 11,283. However, the Rule defines bona fide hedging with reference to 17 C.F.R. §§ 1.3(z)(1) and 151.5, which limit the definition of bona fide hedging to transactions designed to offset exposure in the physical commodity markets only.

Commenters urged a broader definition of bona fide hedging, which would have included transactions undertaken for risk management purposes, and pointed out that the Commission had endorsed a broader definition in other contexts, including large-trader disclosure regulations and mandatory clearing requirements for swaps. *See* SIFMA Comment, at 10; ICI Comment, at 21-22. For instance, in a 1987 release, the Commission stated that it would be "consistent with the objectives" of the CEA to exempt a broad variety of risk mitigation strategies from trading limits because those transactions, like bona fide hedging transactions, would "be matched by cash or cash equivalent set-asides." 52 Fed. Reg. 34,633, 34,636 (Sept. 14, 1987). In this regard, risk mitigation transactions are similar to bona fide hedging transactions, which are also characterized by an "offsetting position in another . . . market." *Id.* at 34,636 n.10.

The Commission's response was inadequate and irrational. It distinguished "bona fide hedging transactions and those undertaken for risk management purposes" on the ground that "bona fide hedging transactions are unlikely to present the same level of market risk as they are offset by exposure in the physical markets." 77 Fed. Reg. at 11,256. But the Commission did not explain why it was excluding other risk mitigation strategies that are *also* offset by exposure

in another market—a characteristic the Commission noted in 1987 was common to a wide range of risk mitigation transactions. As Commissioner Sommers stated in dissent, "[a] risk mitigation position is, by definition, a position that 'offsets' exposure in another market. Both are hedges and there is no explanation as to why the Commission believes that bona fide hedges are less risky." *Id.* at 11,344.

4. *Adoption Of Specific Trading Threshold.* Finally, the Commission failed to offer a reasoned explanation for its decision to set the non-bona fide hedging threshold at five percent.

There was abundant evidence in the record that a five percent threshold was too low. The Commission in 2003 explained that the five percent threshold had come to limit the activities of investment companies "to a much greater extent" than originally intended, due to changes to margin levels for stock index futures and security futures. *See* 2003 Proposing Release at 12,625. And, in the instant rulemaking, the Commission acknowledged that "margin levels for securities product futures are significantly higher" than five percent and that "levels for swaps margining may be as well." 77 Fed. Reg. at 11,256; *see also* Institutional Investors Comment, at 6-7 (stating that "[t]he five percent limit does not reflect current market practices"). Yet the five percent threshold adopted by the Commission will be even *more* restrictive than the threshold that it eliminated in 2003, due to the inclusion of swaps.

The Commission did not provide a reasoned explanation for its decision to again set the threshold at five percent. The Commission stated that it "believes . . . that trading exceeding five percent of the liquidation value of a portfolio evidences a significant exposure to the derivatives markets" and "should subject an entity to the Commission's oversight." 77 Fed. Reg. at 11,256. But the Commission provided no explanation or support for this "belief." *See*, *e.g.*, *McDonnell Douglas Corp. v. U.S. Dep't of Air Force*, 375 F.3d 1182, 1190 (D.C. Cir. 2004). The Commis-

sion also stated that it had "previously determined that five percent is an appropriate threshold," citing a rulemaking that imposed a five percent threshold on certain CPOs with "accredited" investors. 77 Fed. Reg. at 11,256 (citing 2003 Adopting Release at 47,225). The Commission failed to mention that it had reached the *opposite* conclusion with respect to investment companies in the *very same* rulemaking, in which it eliminated the five percent threshold in favor of an exclusion of *all* registered investment companies. *See* 2003 Adopting Release at 47,224.

The Commission also acknowledged that "current data and information does not allow the Commission to evaluate the difference in market impact at various threshold levels." 77 Fed. Reg. at 11,278. Numerous commenters recommended that the Commission engage in further study to obtain that necessary data. *See* Vanguard Comment, at 8; Invesco Comment, at 3. The Commission failed to do so, without explanation.

V. The Commission Did Not Offer The Public A Meaningful Opportunity To Comment.

Finally, the Rule must be vacated because the Commission violated the distinct APA command that an agency "give interested persons an opportunity to participate in the rule making." 5 U.S.C. § 553(c). This requires the agency to set forth in its notice of proposed rulemaking the reasoning and factual material relied upon to formulate its rule. *See, e.g.*, *Nat'l Mining Ass'n v. Mine Safety & Health Admin.*, 116 F.3d 520, 531-32 (D.C. Cir. 1997) (per curiam).

The notice provided by the Commission fell short, first, because the discussion of costs and benefits in the notice did not give commenters adequate notice of the basis for the Commission's cost-benefit analysis. The Commission provided less than a page of cost-benefit analysis in the notice, and of that less than one full sentence was addressed specifically to the costs and benefits of the trading and marketing thresholds. *See* 76 Fed. Reg. at 7,988 ("[F]ailing to adopt revisions to [Section] 4.5 . . . would result in disparate treatment of similarly situated collective

investment schemes . . . ."). This sparse statement did not give commenters an opportunity to address the Commission's assessment of the Rule's costs and benefits, and thus did not comply with the APA. *See Chamber of Commerce v. SEC*, 443 F.3d 890, 901-05 (D.C. Cir. 2006).

Second, the Commission did not give commenters adequate notice of a seven-factor test that the Commission set out in the rule release and that, the Commission announced, would guide application of the marketing threshold. *See* 77 Fed. Reg. at 11,259. These factors were set out nowhere in the notice; although they were proposed by a commenter, an agency cannot "bootstrap notice from a comment." *AFL-CIO v. Donovan*, 757 F.2d 330, 340 (D.C. Cir. 1985).

CONCLUSION

For these reasons, the Commission's amendments to Sections 4.5 and 4.27 were arbitrary and capricious, failed to comply with the cost-benefit provisions of the CEA, and should be vacated.

Dated: May 18, 2012

Respectfully submitted,

/s/ Eugene Scalia

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 18th day of May, 2012, I caused the foregoing Motion for Summary Judgment to be filed and served via the Court's CM/ECF filing system.

/s/ Eugene Scalia

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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

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

Plaintiffs,

v.

UNITED STATES COMMODITY FUTURES TRADING COMMISSION,

Defendant.

Civil Action No. 1:12-cv-00612 (BAH)

[PROPOSED] ORDER GRANTING
PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT

Upon consideration of Plaintiffs' Motion for Summary Judgment, the response of the United States Commodity Futures Trading Commission thereto, Plaintiffs' reply, and all other arguments submitted to the Court in the parties' papers and at oral argument, it is hereby

ORDERED that Plaintiffs' motion for summary judgment is **GRANTED**; and it is further

ORDERED that the amendments to 17 C.F.R. §§ 4.5 and 4.27 promulgated by the United States Commodity Futures Trading Commission on February 24, 2012, and set forth at 77 Fed. Reg. 11,252 and 77 Fed. Reg. 17,328, are **ENJOINED** and **VACATED**.

ENTERED this ____ day of __________________, 2012.

____
The Honorable Beryl A. Howell
United States District Judge

cc:

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