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' SUPPLEMENTAL SUBMISSION IN RESPONSE TO THE COURT'S INQUIRY CONCERNING THE DEFINITION OF "BONA FIDE HEDGING"

In response to this Court's question whether the vacatur of the Commission's definition of "bona fide hedging" in *International Swaps & Derivatives Ass'n v. CFTC*, No. 11-cv-2146 (RLW) (D.D.C. Sept. 28, 2012) ("*ISDA*"), affects the validity of the rulemaking under review here, the Commission provides a remarkable answer: In practical effect, it suggests, the definition has not been vacated at all. The Commission's answer fails to give effect to the *ISDA* decision, compounds the uncertainty created by the procedural irregularities that pervade this rulemaking, and demonstrates the pressing need for vacatur by this Court.

1. There is no question that *ISDA* vacated new Section 151.5, as well as the Commission's extensive amendments to Section 1.3(z)(1)—both of which are incorporated by reference in amended Section 4.5. The Court in *ISDA* was clear about the remedy granted; it vacated the *entire* position limits rule, with the *only* exception being a provision not at issue here. *See* D.E. 70, No. 11-cv-2146, at 1 (ordering "that the final rule and interim final rule promulgated by defendant United States Commodity Futures Trading Commission set forth at 76 Fed. Reg.

71,626 is VACATED with the exception of the rule's amendments to 17 C.F.R. § 150.2"). The Commission's staff admits as much in its October 12 no-action letter, which states that "the position limits rule that promulgated Commission Regulation 151.5, and amended Commission Regulation 1.3(z)(1), was vacated by a court of law." D.E. 36 Ex. A ("Letter"), at 1.

Before this Court, the Commission downplays the significance of that vacatur, intimating that the *ISDA* decision did not "indicate that [new Section 151.5 and amended Section 1.3(z)(1)] were in any way flawed." D.E. 36 ("Supp. Memo."), at 2. But in truth, vacatur is a powerful indication that the Court determined the bona fide hedging definitions to be flawed. Plaintiffs in *ISDA* specifically challenged the hedging definition, *see* D.E. 1, at 30; D.E. 14, at 24; D.E. 31, at 44, No. 11-cv-2146, and the fact that those amendments were integral, controversial elements of a rulemaking that the Court determined to be flawed *in full*, and in its very premise, is in no way exculpating. The Court knew perfectly well how to except certain provisions from the scope of its order, and did not do so for Sections 1.3(z)(1) or 151.5.

In any event, the nature of the violation found in *ISDA* is separate and distinct from the scope of the remedy granted, and the Commission is wrong to cloud the two. The commitment, in the no-action letter, by the staff of the CFTC's Division of Swap Dealer and Intermediary Oversight not to "recommend" that the Commission commence an enforcement action if funds rely on the terms of the now-vacated definitions of bona fide hedging does not change the fact that Section 4.5 specifically incorporates one provision that *no longer exists* because it was vacated by this Court, as well as a second provision that was *significantly amended* in the now-vacated rulemaking.

Moreover, the staff's no-action letter provides no relief at all for entities that qualify for the bona fide hedging exemption under the previous version of Section 1.3(z)(1), but that would

not qualify under amended Section 1.3(z)(1) or under Section 151.5 as adopted in the position limits rule and purportedly re-adopted by the staff letter. For those entities, the letter is not a promise of non-enforcement; it is a threat to apply a more restrictive definition of bona fide hedging than the definition now on the books after the *ISDA* decision. It is a "yes-action letter"—a creature unknown in administrative law. *Cf. Syncor Int'l Corp. v. Shalala*, 127 F.3d 90, 96 (D.C. Cir. 1997) (agency violated APA notice-and-comment requirements by issuing letter labeled as "guidance" and "policy statement" that expanded agency's regulatory jurisdiction to include previously unregulated entities).

For entities that would prefer the amended version of Section 1.3(z)(1) and Section 151.5, the letter purports to bind only one particular Division of the Commission, not the Commission as a whole. *See* Letter 11. It also might not bar lawsuits under the Commodity Exchange Act's private right of action. *See* 7 U.S.C. § 25. And even if it swept more broadly, the Commission cannot re-write its regulations through a staff letter; the reference to the now-vacated provisions remains unaltered in the Code of Federal Regulations. *Cf. Mobile Oil Corp. v. EPA*, 35 F.3d 579, 584-85 (D.C. Cir. 1994) (vacating re-promulgation of rule because agency failed to comply with procedural requirements of APA when re-instating the vacated provisions); *AFL-CIO v. Chao*, 496 F. Supp. 2d 76, 84-85 (D.D.C. 2007) (same). The Commission's claim to the contrary exacerbates the procedural irregularities that permeate this rulemaking, fails to give effect to this Court's judgment in *ISDA*, and belies the plain text of Section 4.5.

2. The Commission's reliance in this rulemaking on a now-vacated definition of bona fide hedging requires vacatur of the Rule. The Commission necessarily premised its cost-benefit analysis—to the limited extent it performed such an analysis at all—on the definition of bona fide hedging promulgated in the position limits rule. It "assumed the validity of that rule, which

[this Court has] since vacated . . . and remanded to the Agency for reconsideration." *Solite Corp. v. U.S. E.P.A.*, 952 F.2d 473, 493 (D.C. Cir. 1991). Because that definition has been vacated, and might not be re-promulgated in the same form (or, indeed, might not be re-promulgated *at all*), the Rule at issue in this litigation "must also now" be vacated. *Id.*; *see also Mobile Oil Corp.*, 35 F.3d at 584 (noting that *Solite* "vacated [one rule] on the ground that it assumed the validity of [another] rule"). Otherwise, the Rule would be allowed to stand on the basis of a cost-benefit analysis whose premise has been vitiated.

In a filing submitted contemporaneously with its submission on bona fide hedging, and purportedly designed to "clarif[y]"—by which it means "correct"—the Commission's statements at argument regarding the operation of the net notional test, the Commission attempts to bolster its cost-benefit analysis by suggesting that, prior to promulgation, it estimated the number of entities likely "affected" by the Rule. D.E. 37, at 2. Yet this estimate—besides being completely absent in the release for the Rule at issue here, and instead found in the notice of proposed rulemaking for the harmonization effort—was likewise premised on the bona fide hedging definition that has now been vacated, and thus further illustrates the degree to which the vacatur of amended Section 1.3(z)(1) and Section 151.5 undermines the already sparse and inadequate cost-benefit analysis conducted by the Commission. Nor are these the only problems with the estimate cited by the Commission. The vague language in which the estimate is couched never reveals what the Commission believes it means for a fund to be "affected"—whether the adviser of an "affected" fund will be required to register and incur the associated costs, whether an "affected" fund will incur monitoring costs and adopt sub-optimal trading strategies to ensure that it stays beneath the registration threshold, or whether an "affected" fund will sell off its commodities-related investments and (as funds did before 2003) studiously avoid meaningful participation in

the commodities markets. The Commission never says, because it never considered the variety of ways funds and their advisers might be affected, or the impact that its Rule would have on the liquidity of the markets for commodity interests, including swaps.

In this respect, the agency's reliance on provisions that have now been vacated is of a piece with the other procedural irregularities that prevented the Commission from performing a meaningful cost-benefit analysis. The Commission forged ahead with this rulemaking despite the fact that the further definition of swap, margin requirements for swap transactions, and the "harmonization" proceeding had not been concluded. And now, one of the few things the Commission thought it *did* know—the definition of bona fide hedging—has been retroactively undone.

3. The uncertainty spawned by vacatur of amended Section 1.3(z)(1) and Section 151.5 is also relevant to the proper remedy for the violations identified in this litigation, as it provides an additional reason why this Court should vacate the Rule, rather than leaving it in effect.

The staff letter does nothing to eliminate the confusion that will result when entities open the Code of Federal Regulations and find a cross-reference in Section 4.5 to now-vacated Section 151.5. And the Commission compounded this confusion by issuing a rule release the day after filing its supplemental pleading with this Court that—astonishingly—treats amended Section 1.3(z)(1) as if it were never vacated. *See* Final Rule, Adaptation of Regulations to Incorporate Swaps at 31 (Oct. 16, 2012) (explaining that "the final rule on Position Limits has already extensively revised [Section] 1.3(z)"), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister101612.pdf. Entities potentially required to register under the Rule must wade through these conflicting signals from the Commission regarding the current state of the law, and must puzzle out the significance of a cross-reference to a provision

that no longer exists. And entities subject to the staff "yes-action letter" must also weigh the risk of an enforcement action by the Commission or a private lawsuit, however unjustified, against their right to rely on the decision of this Court in *ISDA* vacating the amendments to Rule 1.3(z)(1). Vacatur of the Rule will avoid this unnecessary confusion.

The uncertainty is all the more pressingly significant given the Commission's apparent position—contrary to the text of the rule release, and, to our knowledge, expressed by the Commission only in this litigation—that the requirement to file Form CPO-PQR under Section 4.27 will become effective immediately upon registration as a commodity pool operator. Registered investment companies, their investment advisers, and their legal counsel have proceeded in reliance on the plain statement in the rule release that "[e]ntities required to register due to the amendments to § 4.5 shall be subject to the Commission's recordkeeping, reporting, and disclosure requirements pursuant to part 4 of the Commission's regulations within 60 days following the" conclusion of the harmonization rulemaking, 77 Fed. Reg. at 11,252, and are understandably surprised to learn that the Commission does not consider the requirement to report on Form CPO-PQR a "reporting" or "disclosure" requirement—even though it is contained in a section specifically governing "[a]dditional reporting" requirements, 77 Fed. Reg. at 11,285, and is located in "part 4 of the Commission's regulations." If the Commission's interpretation of the compliance date prevails, it will vastly compound the compliance costs of the Rule, as it will subject registered investment companies and their advisers to burdensome reporting obligations far sooner than the industry had contemplated. And that burden will be further aggravated by the need to cope with the uncertainty generated by vacatur of the definition of bona fide hedging, and the possibility that additional entities might now be required to register as commodity pool operators under the Commission's "yes-action" letter.

This Court should avoid this uncertainty, and the concomitant cost to registered investment companies, their investment advisers, and their investors, by vacating this half-baked Rule.

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Respectfully submitted,

/s/ Eugene Scalia

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 22nd day of October, 2012, I caused the foregoing Supplemental Submission in Response to the Court's Inquiry Concerning the Definition of "Bona Fide Hedging" to be filed and served via the Court's CM/ECF filing system.

/s/ Eugene Scalia

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