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**No. 12-5413**

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

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

*Appellants*,

v.

UNITED STATES COMMODITY FUTURES TRADING COMMISSION,

*Appellee*.

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

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

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March 15, 2013

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

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

### A. Parties and *Amici*

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

### B. Rulings Under Review

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

### C. Related Cases

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

## CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1 and D.C. Circuit Rule 26.1, *amici* the National Futures Association ("NFA") and Better Markets, Inc. ("Better Markets") state as follows:

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

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

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

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

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## GLOSSARY OF ABBREVIATIONS

| | |
|---|---|
| APA | Administrative Procedure Act, 5 U.S.C. § 551 *et seq*. |
| Appellants | Investment Company Institute and Chamber of Commerce of the United States of America |
| Appellee | U.S. Commodity Futures Trading Commission |
| Dodd-Frank | Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010) |
| CEA | Commodity Exchange Act |
| CFTC or the Commission | U.S. Commodity Futures Trading Commission |
| CFTC Br. | Brief for U.S. Commodity Futures Trading Commission page citation |
| CPO | Commodity pool operator |
| CTA | Commodity trading adviser |
| Exchange Act | Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq*. |
| ICI Br. | Brief for Investment Company Institute and Chamber of Commerce of the United States of America page citation |
| ICA | Investment Company Act |
| MFDF | Mutual Fund Directors Forum |
| MFDF Br. | Brief for Mutual Fund Directors Forum page citation |

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

## STATUTES AND REGULATIONS

The Briefs for Appellants and Appellee contain the pertinent statutes.

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

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

NFA is the independent SRO for the U.S. futures industry whose fundamental mission is protecting the integrity of the U.S. futures market. NFA is a direct outgrowth of the 1974 Commodity Exchange Act ("CEA"), 7 U.S.C. § 21, which gave the CFTC jurisdiction over commodity futures trading and authorized the futures industry to create a national SRO. To fill this role, NFA formed as a not-for-profit membership corporation. Its regulatory function began in 1982. It a "registered futures association" with the CFTC and is subject to CFTC oversight. NFA membership is mandatory for any CPO or CTA that transacts futures business with the public. NFA's members include more than 3,950 firms registered with the CFTC and approximately 54,250 individuals who conduct

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[1] No party's counsel authored this brief in whole or in part, and no person other than *amici* funded the preparation of this brief. Better Markets and NFA are joining together in one brief pursuant to the Court's briefing order. Section I reflects the arguments prepared by NFA, and Section II reflects the arguments prepared by Better Markets. Although the parties do not object to the filing of this Brief, Appellants have objected to *amici's* motion for permission to file a 10,000 word brief. That motion remains pending at the time of this filing.

business with the public on U.S. futures exchanges. More than 1,600 members are CPOs.

NFA provides regulatory programs and services that ensure futures industry integrity, protect market participants, and help members meet their regulatory responsibilities. NFA establishes and enforces rules and standards for customer protection, which apply to CPOs, CTAs, and other persons and entities that transact business with the public. Members must comply with ethical standards, including prohibitions against fraud, manipulative and deceptive acts and practices, and unjust and inequitable dealings. Members also must comply with specific procedures for supervising employees and handling discretionary accounts.

NFA has a strong interest in this appeal and submits this brief to advise the Court of the vital public interest that is served by the CFTC's recent amendments to Rules 4.5 and 4.27, and to explain the harm to retail investors if the Rule were invalidated. NFA is uniquely positioned to discuss these matters, not only because of its unique regulatory role, but also because it authored the rulemaking petition that ultimately resulted in the Rule's promulgation.

In submitting this brief, NFA emphasizes the importance of providing the investing public with broad access to the derivatives markets. To protect retail investors, in particular, and the effective functioning of the derivatives markets,

however, it is essential that regulation of derivatives allow investors to make decisions with full knowledge of the financial risks and costs they assume.

The ICA applies only to RICs, not their investment advisors or their selling broker-dealers, which are subject to different statutes. FINRA is an SRO with jurisdiction over registered representatives of broker-dealers and their employers. Importantly, CPOs—where offering a RIC/pool or otherwise—are not members of FINRA. By contrast, NFA's enforcement and regulatory jurisdiction over CPOs is integrated in one self-regulatory entity with comprehensive jurisdiction and authority, and is more expansive than the statutory authority of the SEC or the jurisdiction of FINRA.

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

Better Markets has an interest in this case because Appellants claim that the CFTC failed to conduct an adequate "cost-benefit analysis" when it promulgated the Rule. A decision invalidating the Rule on this ground would (1) eliminate the investor protection and market oversight tools that the Rule provides; (2)

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

## BACKGROUND

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

By requiring registration of RICs that cannot qualify for amended Rule 4.5's exclusion from the definition of CPO, the CFTC provides a substantial and meaningful benefit to retail investors by, in part, subjecting affected RICs to the CFTC's comprehensive reporting and other regulatory requirements applicable to CPOs. CFTC registration also brings CPOs within the purview of NFA's mandatory membership requirement. Without CFTC registration and NFA membership, neither the CFTC nor NFA have oversight over RICs engaging in derivatives transactions, regardless of the extent of that activity, thereby putting investors at risk.

The CFTC and NFA have an efficient, decades-old relationship. The CFTC and NFA routinely share information about registered entities. NFA performs background checks on derivatives professionals, maintains a website to alert the

public to registration and disciplinary information, and administers checks on competency, including the National Commodity Futures Examination, which tests applicants' knowledge of the derivatives markets, rules, and regulations. These are not subjects covered in examinations of securities professionals by FINRA, because FINRA does not regulate CPO activities.

NFA also maintains important regulatory information relating to the identity, organization, offices, business records, rates of return, business relationships, and investments of Member CPOs. This information allows NFA to monitor risks associated with registered CPOs, monitor market developments, make inquiries, and intervene quickly when there is evidence of potential violations of NFA rules or potential risks that may affect markets, traders, individual CPOs, and other intermediary firms doing business with CPOs.

NFA Members are required to comply at all times with the rules and regulations of NFA and the CFTC. To monitor and assure compliance, NFA conducts periodic on-site regulatory examinations to ensure that Members properly maintain accurate records and to protect customers against unscrupulous activities and fraud. During examinations, NFA reviews and tests Member CPOs' sales practices and materials, accounting procedures, financial records, risk management practices, internal controls, disclosures regarding all fees (e.g., a break-even analysis) and risks, performance calculations and representations, and trading

records. NFA's and the CFTC's regulatory requirements relating to these areas, developed over the years with specialized knowledge and skill, provide critical protections to commodity pool investors. Investors in RICs that are engaged in more than a *de minimis* amount of derivatives trading should be afforded these protections.

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

In 1985, the CFTC adopted Rule 4.5 which, originally excluded from CPO registration RICs that used derivatives for hedging only where: (1) all of the RIC's commodity interest transactions were bona fide hedges or other anticipatory hedges; (2) the RIC did not use more than 5% of its assets as initial margin in relation to derivatives trading ("*de minimis* trading restriction"); and (3) the RIC was not marketed as a commodity pool or other vehicle for trading in commodity interests ("no-marketing restriction"). 50 Fed. Reg. 15,868 (Apr. 23, 1985). This regulatory framework remained in place for almost a decade, until 1993, when the CFTC amended Rule 4.5 to slightly broaden the *de minimis* trading restriction by removing the condition that the derivatives trading be for hedging only. Following that amendment, a RIC could engage in an unlimited amount of bona fide hedging activity – and other risk management and speculative strategies – and still qualify for the exclusion, provided no more than 5% of its assets were used as initial margin. 58 Fed. Reg. 6,371 (Jan. 28, 1993). This broader *de minimus* trading

restriction and the no-marketing restriction remained in place for another decade until 2003, when they were eliminated during the financial deregulation movement. *See* 68 Fed. Reg. 47,221, 47,223 (Aug. 8, 2003).

The CFTC's decision to eliminate these restrictions in 2003 – thereby excluding essentially all RICs from the CPO definition – resulted from a very different investment and financial regulatory environment than exists today. The CFTC explained that eliminating this oversight was appropriate given the "investment environment" at the time and would "have no effect . . . on the financial integrity . . . of the commodity futures and options markets." 68 Fed. Reg. 47,221, 47,223, 47,230 (Aug. 8, 2003). The CFTC also explained then that, since investment companies are "'otherwise regulated,' the Commission believes that . . . these persons and entities may not need to be subject to any commodity interest trading criteria to qualify for relief under Rule 4.5." 68 Fed. Reg. 12,622, 12,625-12,626 (Mar. 17, 2003).

Thus, based on investment conditions in 2003 and the determination that they were already "otherwise regulated," RICs have enjoyed nearly a decade of categorical exclusion from CFTC regulation as CPOs, regardless of the volume or purpose of their derivative trading, or how they market the units issued by the investment companies.

## III. RESPONSES BY CONGRESS, NFA, THE CFTC, AND THE SEC TO THE FINANCIAL CRISIS: DODD-FRANK, THE CFTC'S ELIMINATION OF THE REGULATORY EXCLUSION FOR RICS, AND THE SEC CONCEPT RELEASE ON THE REGULATION OF DERIVATIVES

Times have drastically changed since 2003. The unprecedented crisis in the financial markets in 2007-08 ushered in a new era. With the painful regulatory lessons of that crisis, Congress became deeply concerned about systemic market risks posed by extensive unregulated investments in derivatives. In 2010, Congress passed Dodd-Frank, which provided for a separate definition of commodity pool, and expressly extended the CFTC's jurisdiction over "swaps." Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 7 U.S.C. §§ 1a(1) & 1a(11)).

Just a month after Dodd-Frank's enactment, NFA filed a rulemaking petition requesting that the CFTC (1) reinstate Rule 4.5's *de minimis* trading and no-marketing restrictions, and (2) make investment companies that cannot meet these requirements ineligible for the exclusion in Rule 4.5.[2] The CFTC issued a Notice of the petition on September 17, 2010. 75 Fed. Reg. 56,997 (Sept. 17, 2010).

The concerns discussed in NFA's petition – and recognized by the CFTC's Notice – provide an important backdrop for the Rule. As NFA described, instead of directly and openly investing in commodity futures transactions, several RICs

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

have been using wholly-owned and controlled subsidiaries to make those investments on their behalf. NFA Pet. 3-4, 6-9. While the offering materials for these RICs indicate that the subsidiaries are subject to certain investment restrictions applicable to the RICs themselves, the reality is that the derivatives trading activities of these subsidiaries are not regulated by anyone – not the CFTC or NFA, nor are they subject to the ICA's investor protection regime. *See id*.

To put it starkly, certain RICs took full advantage of the 2003 amendments to Rule 4.5 and began to extensively – and in some cases exclusively – use derivatives in their investment strategies, and directly market units in these investment companies to retail investors as commodity investments with minimum investments as low as $2,500. These RICs are *de facto* commodity pools that fall entirely outside the CFTC's and NFA's customer protection regulatory regime. *See id*. They are offering their units to investors without any regulatory requirement that the past performance of similar funds be disclosed. Because of the use of wholly-owned subsidiaries, the nature and amount of the fees that are passed on to the parent investment company and its investors is wholly opaque in most instances.[3] This lack of disclosure, transparency, and regulatory oversight is completely at odds with the intent of Dodd-Frank, the regulatory environment

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

triggered by the 2007-08 financial crisis, and the CFTC-SEC jurisdictional boundaries that clearly delineate who has regulatory oversight over derivatives transactions.

Given the use of derivatives by certain RICs, NFA argued to the CFTC that one of the key premises for the 2003 amendments to Rule 4.5 – that investment companies were "otherwise regulated" regarding their derivatives trading – is no longer true. *Id*. at 10. Based on this material change in the investment environment, NFA urged the CFTC to amend Rule 4.5 to restore the *de minimus* trading and no-marketing operating restrictions on RICs in effect prior to 2003. *Id*. at 11. Indeed, only by rescinding the 2003 amendments could the CFTC – and NFA – exercise regulatory oversight over RICs that either engage in more than a *de minimus* amount of derivatives trading or market units to the public as vehicles for investing in derivatives. As NFA emphasized, the CFTC and NFA are the only regulatory bodies that have the experience, expertise, and jurisdiction to comprehensively and meaningfully regulate managed retail futures products. *Id*. at 10 ("The CFTC alone has the Congressional mandate to regulate retail managed futures trading and products, and over the years has developed the specialized body of skill and knowledge necessary to fulfill this mandate.").

NFA's petition had its desired effect. In February 2011, the CFTC issued a Notice of Proposed Rulemaking that cited NFA's petition and proposed to amend

Rule 4.5 to rescind or narrow several exemptions and exclusions, including the CPO exclusion for RICs. 76 Fed. Reg. 7,976, 7,983-7,984 (Feb. 11, 2011). The CFTC further noted that the proposed changes were designed to "bring the Commission's CPO . . . regulatory structure into alignment with the stated purposes of [] Dodd-Frank." *Id.* at 7,978. The CPO definition, as revised by Dodd-Frank, includes a subsection that permits the CFTC to exclude persons or entities from the definition by rule or regulation, if the CFTC determines that the exclusion will "effectuate the purposes of this [Act]." 7 U.S.C. §§ 1a(10)(B) and 1a(11)(B).[4]

On February 24, 2012, the CFTC amended Rule 4.5 to re-impose the *de minimis* trading and no-marketing restrictions upon RICs seeking to avail themselves of the CPO exclusion. 77 Fed. Reg. 11,252 (Feb. 24, 2012). The restrictions were similar to those rescinded in 2003, although the CFTC made several modifications based on comments it received in the rulemaking process. In particular, apparently in response to investment company commenters, the CFTC adopted an alternative *de minimis* trading restriction, providing that an investment company's aggregate notional value of commodity futures, commodity options,

[4] Among Dodd-Frank's amendments to the CEA was the revision and renumbering of these sections; substantively, it changed the CPO definition to explicitly include swaps among its non-exclusive list of covered commodity interests. 7 U.S.C. § 1a(10).

and swaps cannot exceed 100% of an investment company's net liquidating value. *See* Rule 4.5(c)(2)(iii)(B).[5]

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

The Rule also recognizes the CFTC's willingness to contain costs by harmonizing regulations with the SEC. In the same vein, the CFTC has proposed certain disclosure, reporting, and record-keeping changes in an accompanying release. Although the comment period has closed, that rulemaking is still open. 77 Fed. Reg. 11,345 (Feb. 24, 2012). The CFTC utilized a similar harmonization

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

process in 2011, when it adopted amendments to rules applicable to certain commodity exchange traded funds. *See* 76 Fed. Reg. 28,641 (May 18, 2011).

Finally, as part of its compliance with Section 15(a), the CFTC considered various costs that RICs will incur because of the elimination of the exclusion and the requirement that they register as CPOs. These costs include those associated with the CFTC registration process and NFA membership. Most of these costs are *de minimis*, including initial registration fees of $85 and $200, annual membership dues of $750, and other miscellaneous compliance costs. *See* NFA Rule 203; NFA Bylaw 1301.[6]

Not long after the CFTC announced its proposed rulemaking in 2011, the SEC separately announced that it was reviewing RICs' use of derivatives. It issued a request for comments "on a wide range of issues . . . including the potential implications for fund leverage, diversification, exposure to certain securities-related issuers, portfolio concentration, valuation, and related matters." SEC Concept Release, *Use of Derivatives by Investment Companies Under the Investment Company Act of 1940*, 76 Fed. Reg. 55,237 (Sept. 7, 2011) ("SEC

[6] Except where otherwise noted, all of the NFA rules and bylaws referenced in this Brief can be found in NFA's Manual, available on NFA's website at http://www.nfa.futures.org/nfamanual/NFAManual.aspx.

Concept Release").[7] Investment companies are subject to the regulatory framework set forth in the ICA, a core purpose of which is to protect investors from the potential adverse effects of leverage. *See* 15 U.S.C. § 80a-1(b)(7) (stating that the national public interest and the interest of investors are adversely affected "when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities").

The SEC Concept Release explained that "[t]he dramatic growth in the volume and complexity of derivatives investments over the past two decades, and funds' increased use of derivatives, have led the [SEC] . . . to initiate a review of funds' use of derivatives under the [ICA]." 76 Fed. Reg. at 55,238. The SEC specifically noted that "derivatives can raise risk management issues for a fund relating, for example, to leverage, illiquidity . . . , and counterparty risk, among others," and that the purpose of its review "is to evaluate whether the regulatory framework, as it applies to funds' use of derivatives, continues to fulfill the purposes and policies underlying the Act and is consistent with investor protection." *Id*. The SEC stated further that it "intends to consider the comments

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[7] The SEC generally uses the phrases "investment company," "fund," and "mutual fund" interchangeably to refer to a specific type of RIC, the open-end management company.

to help determine whether regulatory initiatives or guidance are needed to improve the current regulatory regime for funds." *Id*. at 55,237.

## ARGUMENT

As reflected below in Section I, among the many lessons learned from the turmoil in the financial markets and the related global economic crisis of the past five years is the importance that the investing public has full disclosure of the risks and costs associated with different types of investments. There is a particularly compelling interest in disclosing levels of risk when it comes to RICs' use of derivatives which, by their very nature, are highly risky due to leverage. The CFTC unquestionably has the legal authority to regulate in this area and the Rule will restore the reach of the CFTC's regulatory oversight to again include RICs that use derivatives beyond a *de minimis* amount and/or that market units in the RIC as a commodity pool or otherwise as a vehicle for trading in commodity interests. This will ensure that these RICs specifically disclose the risks associated with their use of derivatives, positions they take in derivative markets, past performance information regarding other similar funds, and all fees and costs by way of a break-even analysis. In other words, the Rule will protect retail investors by ensuring that RICs provide them with the information they need to evaluate the risks and costs of investments in derivatives.

The Rule targets a broad array of transactions that are not covered by the ICA and are currently unregulated by either the SEC or the CFTC. By amending Rule 4.5 to re-impose operating restrictions in place prior to 2003, the CFTC has eliminated a significant regulatory gap created nearly a decade ago, which has resulted in insufficient oversight and disclosures for investors in certain investment companies. The Rule is thus supported by a compelling public interest and easily satisfies the deferential arbitrary and capricious standard that applies to agency rulemaking.

As reflected in Section II below, the CFTC further fulfilled its duty to consider the costs and benefits of the Rule. First, Section 15(a) of the CEA imposes a limited obligation on the CFTC to consider the costs and benefits of its rules in light of five specific factors, which **focus on protecting the public interest**. Congress's choice of words in Section 15(a), and the relevant case law, make clear that the CFTC has broad discretion in discharging this duty. The CFTC has no obligation to quantify costs or benefits, weigh them against each other, or find that a rule will confer a net benefit.

Second, as the CFTC and any reviewing court considers the costs and benefits of rules implementing financial reform after the 2008 financial crisis, they must give proper weight to Congress's overriding objective embodied in Dodd-Frank. That objective is to institute a comprehensive set of reforms to prevent

another financial collapse and economic crisis. Therefore, as the CFTC fulfilled its duty under Section 15(a), it was obligated to consider the benefits of the entire collection of reforms of which the Rule is an integral part and give greater weight to the unquestionable benefit of preventing another crisis. Against the backdrop of the worst financial and economic crisis since the Great Depression, Congress did not intend that implementation of those reforms should hinge on the outcome of a rule-by-rule cost-benefit analysis that ignores the overriding purpose of the new regulatory framework – and that gives controlling weight to cost concerns from the very industry responsible for the crisis.

Finally, the CFTC satisfied its obligations under Section 15(a). The CFTC amply **considered** the costs and benefits of the Rule. Furthermore, the agency was guided by the need to establish transparency, accountability, and controls on systemic risk throughout our financial system to achieve the ultimate benefit of avoiding another financial crisis.

## I. THE RULE REASONABLY CLOSED A REGULATORY GAP TO PROTECT INVESTORS AND INCREASE OVERSIGHT OF THE DERIVATIVES MARKETS

### A. The Rule provides critical protections for investors in RICs trading in commodities, which exceed those available under the ICA.

The CFTC is the only agency with the expertise and jurisdiction to effectively regulate RICs trading in derivatives. The SEC's jurisdiction reaches

only certain limited types of derivatives. For example, the SEC has jurisdiction over securities-based swaps, and it shares jurisdiction with the CFTC over security futures and certain securities-based swaps called mixed-swaps. 7 U.S.C. §§ 1a(47)(D); 2(a)(1)(A) & 2(a)(10)(D).

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

The CFTC explicitly cited NFA's petition in explaining the basis for the Proposed Rulemaking:

> In 2010, the Commission became aware of certain [RICs] that were offering series of de facto commodity pool interests claiming exclusion under § 4.5. The Commission consulted with market participants and NFA regarding this practice. Following this consultation, NFA submitted a petition for rulemaking in which NFA suggested certain revisions to § 4.5 with respect to [RICs].

76 Fed. Reg. at 7,983. The CFTC incorporated this information by reference in its final rulemaking release. 77 Fed. Reg. at 11,254.

Any suggestion that the Rule is duplicative of existing regulation under the ICA is baseless. That much should be clear from the examples cited in the NFA Petition, which formed part of the basis for the CFTC's decision to re-impose the *de minimis* and no-marketing restrictions. If the examples cited in the NFA Petition were not enough, the fact that the SEC Concept Release is replete with questions regarding the scope and applicability of the present regulatory framework to derivatives should be dispositive. *See* SEC Concept Release.

To be clear, the ICA does not explicitly regulate derivatives at all. However, the SEC has interpreted Section 18(f) of the ICA as reaching certain types of derivatives. That Section prohibits an investment company that is an open-end management company from issuing a "senior security," defined as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends," except that such an investment company may borrow from a bank if it maintains 300% asset coverage over all such borrowings. 15 U.S.C. § 80a-18(f). In 1979, the SEC issued ICA Release No. 10666, which interprets Section 18(f). Securities Trading Practices of Registered Investment Companies, ICA Release No. 10666, 44 Fed. Reg. 25,128

(Apr. 27, 1979) ("Release 10666"). Because the signature characteristic of a derivative is the existence of leverage, Release 10666 reasons by analogy that the definition of "senior security" should include derivatives that function like evidences of indebtedness, where payment of principal or interest will stand in front of any dividends or other amounts that might otherwise be paid to owners of common shares, i.e., "externally" leveraged derivatives. *See id.*; *see also* Guidelines for Preparation of Form N-8B-1, ICA Release No. 7221 (June 9, 1972), 37 Fed. Reg. 12,790 (June 29, 1972).

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

Thus, even where Release 10666 applies to a derivatives transaction, retail investors have no reliable means of determining, for example, the volume of

derivatives in which the RIC is trading, the expectations of the performance of those derivatives, or the extent to which the RIC is leveraged in these transactions. Furthermore, Release 10666 provides no guidance at all when a RIC is engaging in derivatives transactions that cannot be characterized as a "senior security." Release No. 10666 is silent on derivatives that are "internally" leveraged, i.e., where the effect of leverage is embedded within the instrument itself. As this description shows, contrary to Appellants' contention, the Rule does *not* regulate issues already addressed by the SEC.

Moreover, the ICA's regulatory framework is ill-suited to address other issues that are inherent to derivatives transactions. For instance, the ICA requires every investment company to declare whether it is "diversified" or "undiversified." 15 U.S.C. § 80a-5(b). Per the SEC Concept Release, "[t]he purpose of the diversification requirements is to prevent a fund that holds itself out as diversified from being too closely tied to the success of one or a few issuers or controlling portfolio companies." SEC Concept Release 49. An investment company's classification is based on the composition and value of the assets that it holds, including securities. However, determining the "value" of a security can be challenging if that security is a derivative. For example, how should a RIC properly value a swap agreement that involves a reference asset not owned by the RIC, but whose change in value drives the price of the swap agreement?

The difficulty of regulating derivatives under the ICA is further demonstrated by Section 12(d)(3) of that Act, which prohibit an investment company from investing in any security issued by, or holding any other interest in, the business of a broker-dealer, underwriter, or registered investment adviser. 15 U.S.C. § 80a-12(d)(3). This section reflects a congressional policy of prohibiting investment companies from investing in securities-related businesses in order to prevent conflicts of interest and inappropriate reciprocal practices. SEC Concept Release 57; Rule 12d3-1, 17 C.F.R. § 270.12d3-1 (2013). However, as the SEC Concept Release emphasizes, whether Section 12(d)(3) applies depends on whether the derivative is exchange-traded, in which case the counterparty is the clearinghouse; whether it is a security issued by the counterparty; or whether the correct analysis is the degree of exposure to a reference asset underlying the derivative. SEC Concept Release 59-60. In short, the SEC's own interpretation of the Act convincingly demonstrates that the ICA is not, and was not intended to be, a comprehensive framework for the regulation of derivatives by investment companies.

Finally, by giving the CFTC and the SEC concurrent jurisdiction over certain types of derivatives transactions and instruments, Congress has indicated its intent that individuals and entities who engage in derivatives trading may be subject to regulation by both agencies. Congress **could** create a statutory exception

in the CEA's definition of "CPO" for individuals and entities that are registered with the SEC or another financial regulatory agency, **but it never has**. In fact, on several occasions, the SEC has attempted to have withdrawn from the CFTC's jurisdiction areas in which they overlap, but Congress rejected those proposals. *See Bd. of Trade v. SEC*, 677 F.2d 1137 (7th Cir. 1982), *vacated as moot*, 459 U.S. 1026 (1982). Instead, Congress has left to the CFTC's discretion the question of who is subject to CFTC regulation as a CPO, empowering the CFTC to exclude individuals and entities when doing so would further the CEA's purposes. 7 U.S.C. §§ 1a(11)(A), 5(b). If entities properly regulated by the CFTC and the SEC find complying with the regulations promulgated by both agencies unduly burdensome, they may seek a legislative remedy. It is not, however, "arbitrary or capricious" for the CFTC to exercise the regulatory authority bestowed upon it by Congress to oversee derivatives transactions engaged in by RICs.

### B. The Rule provides critical protection to investors at minimal cost to affected RICs.

As described, requiring CFTC registration by RICs that cannot qualify for exclusion under the Rule will provide substantial and meaningful benefit to investors and help to protect the market against systemic risk, thereby advancing the purposes of the CEA. Without CFTC registration, neither the Commission nor NFA will have any oversight over RICs engaging in derivatives transactions, regardless of the extent of that activity, thereby putting investors at risk. With the

Rule, affected RICs will be subject to the CFTC's comprehensive regulatory scheme applicable to CPOs, and NFA will also have the ability to examine these RICs for compliance with CPO regulatory requirements. The applicable reporting and disclosure requirements protect retail investors thus far largely kept in the dark about these RICs' derivatives practices.[8]

The assertion of *amici* MFDF and former SEC officials that RICs will incur substantial additional operating costs if they are required to become members of NFA is simply overblown. In particular, if a RIC is presently investing more than a *de minimus* amount in derivatives, its board of directors – in the exercise of its fiduciary duty – may well have already ensured that the RIC's investment advisor has compliance personnel who are qualified in derivatives transactions and regulations. Moreover, RICs should already have many, if not all, of the NFA regulatory requirements in place. For example, it is difficult to imagine that a RIC would not already have established disaster-recovery or business continuity plans. *See* NFA Rule 2-38. And, as described above, other costs associated with NFA-membership are minimal.

[8] Although the ICA requires similar disclosures for entities under its jurisdiction, the SEC-required disclosures often do not require the same level of detail as the CFTC's requirements. For example, the ICA does not require transparency regarding fees as mandated by the CFTC's break-even point fee disclosure nor the disclosure of the investment adviser's past performance for similarly offered vehicles.

Finally, the CFTC is taking affirmative steps to ensure that Appellants' concerns about duplicative regulatory requirements are not realized. To this end, the CFTC has proposed harmonizing its CPO requirements for RICs with the rules under the ICA in the areas of recordkeeping, disclosure, and reporting. 77 Fed. Reg. 11,345 (Feb. 24, 2012). In view of this action, complaints about duplicative regulatory regimes are premature and fail to recognize the CFTC's prior success in a similar harmonization process applicable to CPOs in the context of CFTC-SEC dually regulated commodity pool exchange-traded funds whose units of participation are listed and traded on a national securities exchange, and constitute securities offered under the Securities Act of 1933. *See* 76 Fed. Reg. 28,641 (May 18, 2011).

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

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

#### 1. The obligation to "consider" certain factors is a statutorily-limited duty that confers broad discretion on the CFTC.

Section 15(a) of the CEA simply directs the CFTC to "consider the costs and benefits of the action of the Commission," and "evaluate" those considerations in light of five enumerated "considerations." 7 U.S.C. § 19(a). This wording and the case law construing similar wording make clear that Congress intended the CFTC

exercise broad discretion in fulfilling this obligation. The Supreme Court has long recognized that when statutorily mandated considerations are not "mechanical or self-defining standards," they "imply wide areas of judgment and therefore of discretion." *Sec'y of Agric. v. Cent. Roig Ref. Co.*, 338 U.S. 604, 611-12 (1950) ("Congress did not think it was feasible to bind the Secretary as to the part his "consideration" of these three factors should play in his final judgment—what weight each should be given, or whether in a particular situation all three factors must play a quantitative share in his computation.").

Following this approach, this Court has explained that where "Congress did not assign the specific weight the [agency] should accord each of these factors, [it] is free to exercise [its] discretion in this area." *N.Y. v. Reilly,* 969 F.2d 1147, 1150 (D.C. Cir. 1992); *see also Brady v. FERC*, 416 F.3d 1, 6 (D.C. Cir. 2005). Indeed, when Congress requires an agency to "consider" certain factors in its rulemaking, a reviewing court's role is limited. Courts are not to find a rule arbitrary and capricious under the APA, 5 U.S.C. § 706(2)(A), unless the agency "wholly failed" to comply with a statutory requirement, or if there is a "complete absence of any discussion of a statutorily mandated factor." *Pub. Citizen v. Fed. Motor Carrier Safety Admin.,* 374 F.3d 1209, 1216 (D.C. Cir. 2004).[9]

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[9] The court in *Public Citizen*, 374 F.3d at 1221, suggested that the agency had to "weigh" costs and benefits even though the statute simply required the agency to "consider" them. However, that suggestion was pure dicta, and it arose from

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

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

The five considerations in Section 15(a) reflect Congress's primary concern that regulations serve the public interest and accomplish the agency's mission, not

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detailed and prescriptive language in a separate provision of the applicable statute. *Id.* at 1216.

that industry is spared the inevitable costs of regulation. Without exception, each factor relates to a public benefit that arises from a robustly regulated marketplace, including preventing abuse, promoting competition, enhancing transparency, and limiting systemic risk.[10] None of the factors mentions any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements. *Cf.* 42 U.S.C. § 300g-1(b)(3)(C) (requiring analysis of costs that "are likely to occur solely as a result of compliance"); 42 U.S.C. § 6295(d) (1976 ed., Supp. II ) (requiring a weighing of the economic impact on manufacturers).

Removing any doubt, the fifth factor requires the CFTC to consider "any **other** public interest considerations." 7 U.S.C. § 19(a)(2)(E) (emphasis added). Consequently, under principles of statutory construction, each of the four prior factors derives their meaning from this fifth factor, the public interest. *See Neal v. Clark*, 95 U.S. 704, 708-09 (1877). Thus, Section 15(a) focuses exclusively on public interest considerations.

The CFTC correctly recognized the dispositive role of the public interest under Section 15(a):

> The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding the costs, a particular rule . . . is necessary or

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[10] The focus of Section 15(a) is also evident from its close parallel to the public interest objectives of the CEA, which are reflected in the five factors. 7 U.S.C. § 5(a)-(b).

> appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the CEA.

Proposing Release, 76 Fed. Reg. 7,976, 7,988.

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

The CFTC's statutory obligation is also determined by the conspicuous **absence** of language Congress uses when it intends an agency conduct cost-benefit analysis. The Supreme Court has declared that an agency's duty to conduct cost-benefit analysis is not to be inferred lightly or without a clear indication from Congress. *See Am. Textile Mftrs. Inst., Inc., v. Donovan*, 452 U.S. 490, 510-512 & n.30 (1981) ("Congress uses specific language when intending that an agency engage in cost-benefit analysis."); *see also Whitman v. Am. Trucking Ass'ns, Inc.*, 531 U.S. 457, 471 (2001) (holding that a statute "unambiguously bars cost considerations").

Therefore, when Congress intends cost-benefit analysis to apply, it explicitly refers to "costs" and "benefits" and specifies the nature of the analysis, requiring a specific weighing and often quantification. But, when Congress wants to impose a limited obligation to consider certain costs and benefits in light of important public interest goals, such as Section 15(a), it makes that intention clear, without requiring cost-benefit analysis.

Statutes that mandate a **balancing** of costs and benefits stand in sharp contrast to Section 15(a) and explicitly include language of comparison. *See Am.*

*Textile Mftrs. Inst., Inc.*, 452 U.S. at 511-12, n.30 and statutes cited therein. Accordingly, courts refuse to require a specific balancing of costs and benefits when a statute does not plainly mandate it. For example, the Federal Water Pollution Control Act of 1972, 33 U.S.C. § 1314(b)(2)(B), requires the agency to "take into account" direct and indirect costs and other "appropriate" factors. This Court found that this language does **not** require the agency "to use any specific structure such as a balancing test in assessing the . . . factors" nor "to give each . . . factor any specific weight." *Weyerhaeuser Co. v. Costle,* 590 F.2d 1011, 1045 (D.C. Cir. 1978); *see also Nat'l Ass'n of Home Builders v. EPA*, 682 F.3d 1032, 1039 (D.C. Cir. 2012) (statutes in which agencies must "consider" the "economic" impact or "costs" do not require cost-benefit analysis); *Cent. Ariz. Water Conservation Dist. v. EPA,* 990 F.2d 1531, 1542 n.10 (9th Cir. 1993) (language in statute requiring "consideration" does not require cost-benefit analysis).

Similarly, statutes requiring a **quantification** of costs and benefits, in contrast to Section 15(a), are explicit. *See, e.g.,* 42 U.S.C. § 300g-1(b)(3). Recognizing these deliberate congressional choices, courts have held that an agency need not quantify a rule's costs and benefits when a statute does not require it. *See FMC Corp. v. Train*, 539 F.2d 973, 978-979 (4th Cir. 1976) (finding quantification of the benefits in monetary terms was not required). In fact, this Court has recognized that an agency's "predictions or conclusions" do not

necessarily need to be "based on a rigorous, quantitative economic analysis." *Am. Fin. Services Ass'n. v. FTC*, 767 F.2d 957, 986 (D.C. Cir. 1985).

Congress clearly chose not to require the CFTC to either balance or quantify the costs and benefits of its rules.[11]

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

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

However, reliance on those cases is misplaced. First, they are distinguishable insofar as the statutes at issue are different, particularly the wording of the relevant provisions and the list of economic factors that must be considered. For example, unlike the securities laws, Section 15(a) includes the

[11] The legislative proposals that seek to impose a duty to conduct cost-benefit analysis on the independent regulatory agencies further confirm this view. *See, e.g.*, H.R. 1840, 112th Cong. (introduced May 11, 2011). Such proposals support a finding that an agency's statute does not already mandate cost-benefit analysis. *See Am. Textile Mfrs. Inst*, 452 U.S. at 512 n.30.

explicit reference to "other public interest considerations," a uniquely powerful indication that Congress intended to protect the public interest, not minimize industry costs.

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

In **none of those cases** did the parties argue or the panels address the judicial precedents that interpret "consider" as imposing a limited duty, that require explicit statutory language before finding that cost-benefit analysis applies, and that mandate judicial deference to agency judgments. Those panels also failed to weigh the challenges of cost-benefit analysis and its role as an obstacle to implementation of congressional objectives.

Finally, those cases reflect another error. In finding that the SEC was required to "assess the baseline" level of its statutorily mandated considerations,

*Am. Equity Life Ins. Co. v. SEC*, 613 F.3d at 178,[12] the Court applied principles of cost-benefit analysis found in inapplicable Executive Orders. However, the CFTC and all independent regulatory agencies are expressly **excluded** from those provisions. Executive Order 13,579, 76 Fed. Reg. 41,587 (July 14, 2011); Executive Order No. 13,563, 76 Fed. Reg. 3,821, § 7 (Jan. 21, 2011); Executive Order 12,866, 58 Fed. Reg. 51,735, § 3(b) (Oct. 4, 1993).

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

[12] Even if the CFTC were required to assess some baseline level, it clearly did so as recognized by the lower court. A-67-70; *see also* CFTC Br. 49-52.

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

### C. When considering the costs and benefits of rules implementing financial reform, the CFTC must also consider Congress's overriding goal to prevent another financial crisis.

In considering the costs and benefits of its rules under Section 15(a), the CFTC must also consider and place the highest importance on the overriding objective of the legislation that is the basis for the rule. Here, that legislation is Dodd-Frank and its core objective is preventing another financial crisis.

#### 1. The CFTC's obligation to consider Congress's goal of preventing a future crisis derives from Section 15(a) and from Dodd-Frank itself.

As discussed above, Section 15(a) requires the CFTC to consider not only the enumerated aspects of the public interest, but also "**any other public interest considerations**." This imposes a contextual obligation to consider whatever public interest goals a rule may serve under the prevailing conditions.

The present-day conditions warranting the Rule are obvious: In the aftermath of the worst crisis since the Stock Market Crash of 1929, which triggered the worst economic downturn since the Great Depression, there is no more compelling public interest than preventing another crisis. The Rule serves this purpose, and its costs and benefits must therefore be considered in this context.

A second rationale for a holistic approach springs from Dodd-Frank itself. The fundamental objective of a law confers broad discretion on an agency as it considers the costs and benefits of a rule that is necessitated by that law. *See FMC*

*Corp. v. Train*, 539 F.2d 973, 978-79 (4th Cir. 1976) (rejecting industry's claim that a statute required a comparison and quantification of a rule's costs and benefits, and holding that the agency had broad discretion in assessing the costs given Congress's overriding purpose in the law); *see also Fla. Manufactured Hous. Ass'n v. Cisneros,* 53 F.3d 1565, 1578 (11th Cir. 1995).

Here, the Rule is an integral component of the comprehensive reforms intended by Congress when it passed Dodd-Frank. Although not expressly required, the Rule is necessary and appropriate in light of the specific provisions and goals of the statute. In Dodd-Frank, Congress gave the CFTC authority over an entirely new regulatory regime governing swaps; expanded the definition of CPO to encompass swap transactions; imposed reporting requirements on private fund advisers, which present the same "sources of risk" posed by CPOs; and appointed the CFTC as a member of the Financial Stability Oversight Council, tasked with gathering data, monitoring financial markets, and addressing systemic risk. 77 Fed. Reg. at 11,252-53. Thus, "[f]ollowing the recent economic turmoil, and consistent with the tenor of the provisions of the Dodd-Frank Act," the Commission appropriately reconsidered the level of CPO regulation and adopted the Rule. *Id*. at 11, 253. As recognized by the lower court, the Rule is thus necessitated by and grounded in Dodd-Frank. A-26-29. Its benefits must therefore

be considered in terms of the benefits conferred by the entire collection of Dodd-Frank reforms.

### 2. The indisputable objective of Dodd-Frank is avoiding another financial crisis, and the benefits of achieving that goal are enormous.

The purpose of Dodd-Frank is "[t]o promote the financial stability of the United States" to prevent another financial crisis. Dodd-Frank, Preamble. The statute reflects this purpose through its sheer breadth and detail. Congress's intent was unmistakable: Fundamentally change the regulatory structure so our financial markets can never again generate the levels of risk, recklessness, and abusive conduct that triggered the financial crisis. *See* S. REP. No. 111-176, at 2 (2010).

Indeed, members of Congress consistently recognized the enormous costs of the crisis, and the need "to stop what happened from ever happening again," as the driving forces behind the Act. Senator Dorgan, 156 Cong. Rec. S 5931 (daily ed. July 15, 2010); *see also* Senator Dodd, 156 Cong. Rec. S 2688 (daily ed. Apr. 27, 2010).

The solution was a comprehensive overhaul of the financial system to "put an officer back on the beat on Wall Street so the jobs, homes, and futures of Americans are not again destroyed by excessive greed." Senator Levin, 156 Cong. Rec. S 5931 (daily ed. July 15, 2010). In this context, neither the Rule nor other

elements of regulatory reform can be viewed in isolation, divorced from the larger, congressionally envisioned framework.

The value of reform is enormous, and it includes the benefits of sparing our society and economy the devastating consequences of another financial crisis. By conservative estimates, the crisis that began in 2007 and continues to inflict suffering today will cost our economy **at least $12.8 trillion**. BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf. And the Government Accountability Office has recently found that "the present value of cumulative output losses [from the crisis] could exceed **$13 trillion**." GAO, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, GAO-13-180, at 17 (Jan. 2013) (emphasis added). These estimates serve as a benchmark for the cost of any future financial crisis, and they reveal what is at stake in the regulatory reform process.

Thus, rules promulgated in accordance with Dodd-Frank promise an enormous **collective benefit to the public interest** – avoiding the costs of the crisis we have witnessed since 2007 – but only if they are implemented on a **collective basis**. The CFTC was obligated to, and did, consider these factors, which also must inform this Court's review of the Rule.

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

The CFTC complied with its statutory duty under Section 15(a). It **considered** the costs and benefits of the Rule in light of the enumerated factors, and it appropriately considered the larger benefit of avoiding another financial crisis.

#### 1. The CFTC considered costs and benefits.

The CFTC considered a range of specific costs and benefits associated with the Rule. It catalogued all of the compliance costs of registration and data collection and their attendant variables. 77 Fed. Reg. at 11,272-275, 11,277, 11,281; A-74-75; CFTC Br. 45-47. It also sought to mitigate those costs for dually registered entities while protecting market participants and the public. 77 Fed. Reg. at 11,281. As correctly found by the district court, "the CFTC is not required to promulgate only rules that have low or no costs; rather the agency is simply required to show that they "*considered*" and "*evaluated*" the costs of the rule." A-83 (original emphasis). The agency did this.

Moreover, as detailed by the lower court, the CFTC described the Rule's benefits, which include important investor protections and enhanced regulatory tools that will better equip the CFTC to oversee the swaps markets. A-55-57; *see also* CFTC Br. 44. Registration will help the CFTC ensure minimum levels of competency and fitness and will "provide[] the Commission and members of the

public with a clear means of addressing the wrongful conduct by [registered] individuals and entities." *Id*. at 11,277, 11,254; *id.* at 11,343 (statement of Chairman Gary Gensler) (recognizing the benefits of bringing commodity pools "that have been in the dark back into the light so that their customers can benefit from CFTC's oversight").

Similarly, data collection "increases the amount and quality of information available regarding a previously opaque area of investment activity and, thereby, enhances the ability of the Commission to protect investors and oversee derivatives markets." *Id.* at 11,281. Because the data is not otherwise available, the CFTC "will be able to tailor its regulations to the needs of, and risks posed by, entities in the market, and to protect investors and the general public from overly risky behavior." *Id*.

The rulemaking record highlights the importance of these benefits by describing the nature and magnitude of the threat investment company CPOs, particularly mutual funds, pose to investors and the financial system. The Release cites NFA's petition for rulemaking. *Id*. at 11,254 n.27. That petition indicates that there are "at least three entities filing for exclusions under Regulation 4.5 with respect to registered investment companies that they operate;" that they have the same goal as public commodity pools; that they market themselves to customers as commodity futures investments; and that they indirectly invest substantially in

derivatives and futures to achieve a managed futures exposure equal to the full net value of the fund. A-1433; *see also* Letter from Senators Carl Levin & Tom Coburn to IRS, at 3 (Dec. 20, 2011) (estimating that as many as 72 mutual funds circumvent federal regulation in the same manner as those entities mentioned by NFA).

The Release also explains the decision not to exempt mutual funds from CPO registration. First, their investments are inherently risky, and "a relatively small investment in a derivative instrument can expose a fund to potentially substantial gain or loss – or outsized exposure to an individual counterparty." 77 Fed. Reg. at 11,255. Second, without registration, investors are deprived of crucial information required by the CEA. *Id.*; A-1434. Third, "[s]ince Rule 4.5 is an exclusion rather than an exemption, the anti-fraud provisions of Section 4(o) do not apply," thus depriving investors of important legal protections. A-1433.

Indeed, investment companies acting as unregistered CPOs pose a serious threat to investors: "[i]nvestments in these vehicles can be – and often are – sold to unsophisticated customers." *Id.* Approximately 52.3 million U.S. households (or 44%) own shares in mutual funds, investing mainly for retirement. ICI, *2012 Investment Company Fact Book: A Review of Trends in the U.S. Investment Company Industry*, at 87 (2012). Without the Rule's registration and data collection provisions, these investors are at heightened risk of exploitation at the

hands of up to 8,684 mutual funds that are increasingly inclined to engage in this activity without sufficient oversight. *Id*. at 18; 77 Fed. Reg. at 11,255; *see also CFTC. v. British Am. Commodity Options Corp.*, 560 F.2d 135, 139-140 (2d Cir. 1977) ("Registration is the kingpin in [the CEA], giving the Commission the information . . . which it so vitally requires to carry out its other statutory functions. . ..").

In sum, the CFTC complied with its Section 15(a) duty, comprehensively considering the Rule's costs and benefits.[14]

**2. The CFTC also considered the benefits of preventing another crisis.**

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

The CFTC was fully cognizant of the damage done by the crisis, Congress's resolve to prevent a recurrence of the crisis through Dodd-Frank, and the agency's

[14] The CFTC actually exceeded its duty and "quantified estimated costs and benefits where it [was] reasonably practicable to do so." 77 Fed. Reg. 11,276. Although neither its statute nor the relevant case law requires quantification, the CFTC's effort to do so illustrates its good faith attempt to address industry concerns, despite the fact that "[m]any comments addressed the costs and benefits of the proposed rule in qualitative terms." *Id*. at 11,276. *Cf. BASF Wyandotte Corp. v. Costle*, 598 F.2d 637, 657 (1st Cir. 1979) ("There is no way the cost analysis could be more than an estimate, especially given the reticence of the industry to supply information, and [the agency] needed to develop no more than a rough idea of the costs the industry would incur.").

own duty to promulgate regulations that fulfill the letter and spirit of the law. The rulemaking record confirms that the CFTC considered the need to implement the Rule as part of the regulatory reform effort. The Release observes that "Congress enacted Dodd-Frank in response to the financial crisis," and finds that the Rule would supplement the Act, thus helping to prevent a future crisis. 77 Fed. Reg. at 11,253. The Release also explains that the need to reinstate stronger oversight of CPOs was prompted by "the recent economic turmoil" and is "consistent with the tenor of the provisions of the Dodd-Frank Act." *Id.*; *id*. at 11,275. Commissioner Scott O'Malia, when voting to adopt the Rule, similarly recognized that "[t]he financial crisis . . . highlights the need for more accessible and effective consumer protection measures." Statement of Concurrence, CPOs and CTAs: Amendments to Compliance Obligations, Feb. 2, 2012.

Regarding the registration and data collection provisions, the Release states that "[t]he sources of risk delineated in the Dodd-Frank Act with respect to private funds are also presented by commodity pools," and registration and data collection will help the agency comply with the spirit and letter of the Act's provisions on financial stability. 77 Fed. Reg. 11,252-53. Consequently, according to the Release, data collection will yield "risk mitigation as it pertains to the overall financial stability of the United States," which although not quantifiable, "is significant insofar as the Commission may be able to use this data to prevent

further future shocks to the U.S. financial system." *Id*. at 11,281; *see also* 76 Fed. Reg. at 7,980 (The forms reflect "the purpose and requirements of the Dodd-Frank Act."). Similarly, the inclusion of swaps in the Rule will help ensure that the CFTC can effectively oversee swaps trading, a previously opaque investment activity. 77 Fed. Reg. at 11,252, 11,256, 11,258.

This evidence demonstrates that the CFTC was appropriately guided by a full appreciation of the need for reform and the part the Rule would play in achieving the congressional objective of preventing another financial crisis. *See* CFTC Br. 44. The lower court also recognized the importance of Dodd-Frank in assessing the CFTC's compliance with 15(a), stating that it "does not believe that any more exacting benefit calculation needs to be made in this case, particularly here, where the agency is fulfilling expanded regulatory responsibilities mandated under Dodd-Frank."

## CONCLUSION

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

March 15, 2013

Respectfully submitted,

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## CERTIFICATE OF COMPLIANCE

Pursuant to Federal Rule of Appellate Procedure 32(a)(7)(C) and D.C. Circuit Rule 32(a), I hereby certify that the foregoing brief complies with the applicable type-volume limitations. This brief was prepared in proportionally spaced typeface using Microsoft Word in 14-point Times New Roman font. The brief, excluding the parts exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii) and D.C. Circuit Rule 32(a)(1), contains 9,945 words.[15] This certification is made in reliance on the word-count function of the word processing system used to prepare the brief.

/s/ John M. Devaney
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March 15, 2013

[15] As described above, *amici* have filed a motion requesting permission to file a brief of 10,000 words. That motion remains pending at the time of this filing.

**CERTIFICATE OF SERVICE**

I certify that on March 15, 2013, I caused the foregoing Brief for the National Futures Association and Better Markets, Inc. as *Amici* Curiae in Support of Appellee to be filed with the Clerk of the Court for the United States Court of Appeals for the D.C. Circuit via the CM/ECF system, which will serve counsel listed below.

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