June 26, 2013

Court of Appeals Rejects Challenge to CFTC's Rule 4.5

By Jay G. Baris

The U.S. Court of Appeals for the D.C. Circuit on June 25, 2013 held that the Commodity Futures Trading Commission (CFTC) lawfully adopted amendments to a rule that will require many investment companies to be regulated as commodity pools.

The Court upheld a U.S. District Court ruling against the Investment Company Institute (ICI) and the U.S. Chamber of Commerce (Appellants), who challenged the CFTC's 2010 amendments to Rule 4.5, claiming, among other things, that the CFTC acted in an arbitrary and capricious manner.

Background. As originally adopted in 1985, Rule 4.5 provided that a commodity pool operator (CPO) that was also a registered investment company was included within the CFTC's regulatory definition of a CPO unless it met all of the enumerated requirements for exclusion. Among other things, the original rule required investment companies wishing to rely on the exclusion to:

- Use commodity futures or commodity options by investment companies solely for "bona fide hedging purposes;"
- Not enter into a futures or options contract for which the aggregate initial margin and premiums exceed five percent of the market value of the fund's assets;
- Not hold themselves out as commodity pools; and
- Disclose in writing to each prospective participant the purpose of and limitations on the scope of the fund's futures and options trading.

In 1993, the CFTC removed the bona fide hedging requirement and excluded bona fide hedging from the five percent trading threshold.

Congress enacted the Commodity Futures Modernization Act of 2000. This statute, among other things, barred the CFTC and the SEC from regulating most types of "swaps." In 2003, the CFTC revised Rule 4.5 to eliminate the five percent ceiling.

With the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA), the regulatory pendulum swung in the other direction. The DFA handed the CFTC responsibility for oversight of most swaps, and revised the definition of a CPO to include entities that trade swaps.

In the wake of the DFA, and in the context of the global financial crisis, the National Futures Association (NFA) raised concerns that some investment companies trading extensively in derivatives were relying on Rule 4.5 to evade CFTC regulation as CPOs. The NFA asked the CFTC to roll back Rule 4.5 to the pre-2003 days.

In 2012, the CFTC revised Rule 4.5 to require, among other things:

- Certified regular reports from CPOs
- That, to be eligible for exclusion from the definition of a commodity pool:
    - an investment company's non-bona fide hedging trading must be less than or equal to five percent of the liquidation value of the fund's portfolio, OR
    - the aggregate net notional value of the trading must be less than or equal to 100 percent of the liquidation value of the pool's portfolio.

Rule 4.5, as amended, requires an investment company's investment adviser, rather than the fund itself, to register as a CPO.

The CFTC justified its decision to return to the pre-2003 regulatory framework because of "changed circumstances." That is, increased derivatives trading activities resulted in investment companies providing "services substantially identical" to those of CPOs.

Appellants sued the CFTC in federal district court, claiming that the CFTC violated requirements of the Administrative Procedures Act and the Commodity Exchange Act when they revised Rule 4.5. The lawsuit alleged that the CFTC violated the Administrative Procedures Act and the Commodity Exchange Act on several counts. Among other things, Appellants claimed that the amendments were arbitrary and capricious and an abuse of the CFTC's rulemaking discretion. The Court of Appeals upheld the district court's grant of summary judgment in favor of the CFTC.

The Court of Appeals' decision. The Court of Appeals disagreed with Appellants on each allegation. In particular:

- *Rationale for rules.* Appellants claimed that the CFTC failed to address its own 2003 rationales for broadening the CPO exemptions. The Court said that the CFTC attempted to respond to changed circumstances by tightening registration and reporting requirements.
- *Costs-benefits analysis.* Appellants claimed that the CFTC failed to meet legal standards because it offered an inadequate evaluation of the rule's costs and benefits. Among other things, Appellants said that it would not be possible to determine the costs and benefits of the rule until after the CFTC's proposed "harmonization" rules become effective. (The harmonization rules are intended to minimize overlapping regulation presented by two frequently incompatible regulatory schemes that will apply to investment companies that make extensive use of derivatives.) The Court rejected each argument relating to costs and benefits. The Court said that unlike other cases when it threw out SEC regulations for deficient costs-benefits analysis, the CFTC concluded that it, rather than the SEC, was in the best position to oversee funds engaged in "more than a limited amount of non-hedging derivatives trading." Given the SEC's lack of a "comprehensive and systematic approach" to derivatives related issues, the Court said, the CFTC could fill in the gaps in existing regulation.
- *Swaps.* Appellants claimed that the CFTC's decision to include swap transactions in the five percent registration threshold was arbitrary and capricious. The CFTC responded that participation in swaps would trigger the registration requirement even if the CFTC based its threshold only on futures and options. The Court acknowledged that this response offered "less than ideal clarity." However, the Court said that the CFTC gave sufficient other reasons to justify its rulemaking.

- *Bona fide hedging.* Appellants said that the definition of bona fide hedging transactions was too narrow, and should encompass risk management strategies. The Court rejected this argument, characterizing the argument as "nothing more than another policy disagreement with the CFTC."
- *Five percent threshold.* Appellants argued that the five percent registration threshold for Rule 4.5 is too low. Here, the Court deferred to the CFTC's judgment and held that the five percent threshold was neither arbitrary nor capricious.
- *Notice and comment.* Appellants argued that the CFTC failed to provide adequate opportunity for notice and comment. The Court rejected this argument as well, saying that the appellants failed to show that any prejudice resulted from the failure to follow the strict requirements of the notice rule.

Observations. The Court of Appeals' decision is yet another striking example of how the pendulum has swung toward the side of more regulation, following a period of "hands off" regulation leading up to the financial crisis of 2008. The CFTC has yet to finalize the harmonization rules, which are sure to generate some controversy and lead to additional compliance costs.

We expect that once Rule 4.5 is fully implemented, fund prospectuses that fall within the definition of "commodity pool" will grow in girth and complexity, and compliance costs will increase, as will legal costs. It remains to be seen whether any of these additional regulatory burdens will in any way benefit the shareholders of these funds.

Contact:

Jay G. Baris
(212) 468-8053
jbaris@mofo.com

Luke T. Bagley
(212) 336-4379
ltb2@mofo.com

Kelley A. Howes
(303) 592-2237
khowes@mofo.com

Robert E. Putney, III
(212) 336-4451
rputney@mofo.com

Isabelle Sajous
(212) 336-4478
isajous@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for 10 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.