D.C. District Court Rejects Challenge to CFTC Rule 4.5 Amendments

On December 12, 2012, the U.S. District Court for the District of Columbia dismissed a lawsuit challenging recent amendments to Rule 4.5 (the "Amended Rule") promulgated by the Commodity Futures Trading Commission (the "CFTC") under the Commodity Exchange Act. The Amended Rule has been a topic of intense focus by the mutual fund industry because it will subject many registered investment companies and their investment advisers to regulatory oversight by the CFTC and the National Futures Association (the "NFA"). The court rejected in their entirety the principal claims advanced on behalf of the mutual fund industry by the plaintiffs, the Investment Company Institute and the U.S. Chamber of Commerce, finding that "the CFTC considered the relevant factors [and] acted well within its discretion," and that the CFTC's regulatory action was neither arbitrary nor capricious. The text of the court's opinion can be found here.

Investment advisers to registered investment companies that do not qualify for the exclusions from registration under the Amended Rule will be required to register with the CFTC by December 31, 2012, although they will not have to comply with certain recordkeeping, reporting and disclosure requirements until 60 days following the effectiveness of the final "harmonization" rule. As of the date of this alert, the CFTC had not announced when the final harmonization rule will be adopted.

The Amended Rule

Under the Commodity Exchange Act and the rules promulgated thereunder, an investment company that trades in commodity futures, options on commodities or commodity futures, swaps or certain other products is considered a "commodity pool," obligating its "operator" (typically the primary investment adviser) to register with the CFTC as a "commodity pool operator" ("CPO") unless the fund satisfies the requirements for one or more exemptions under rules promulgated by the CFTC. The amendments to Rule 4.5 limit the availability of one of these exemptions, relied upon by many mutual funds, by reinstating and augmenting certain trading limits and marketing restrictions on the use of CFTC-regulated derivatives that the CFTC had previously eliminated in 2003 as part of a broader approach to deregulation of derivatives markets. Rule 4.27, a new rule proposed at the same time as the amendments to Rule 4.5, requires advisers to mutual funds that are registered as CPOs to submit reports to the CFTC. Furthermore, because many investment advisers and sub-advisers to mutual funds were previously exempt from registration as commodity trading advisers ("CTAs") based, in part, on the fact that the funds they advised were not commodity pools, the Amended Rule triggers CTA registration for many investment advisers. More information about the prior Rule 4.5 and the Amended Rule is available in Ropes & Gray's February 14, 2012 alert here.

In addition, in February 2012, the CFTC proposed amendments to its disclosure, recordkeeping and reporting rules (the "Harmonizing Amendments") in order to minimize certain conflicts between CFTC rules and Securities and Exchange Commission ("SEC") rules applicable to registered investment companies whose trading subjects their advisers to registration as CPOs. The text of the CFTC's proposing release for the Harmonizing Amendments is available here. Comments on the Harmonizing Amendments were due in April 2012 and the CFTC has not yet published a final release concerning the Harmonizing Amendments.

The District Court Found That the CFTC Provided Reasoned Justification for the Amended Rule

The plaintiffs challenged the Amended Rule on the grounds that the CFTC's rulemaking was arbitrary and capricious in violation of the Administrative Procedure Act and that the CFTC failed to perform an adequate cost-benefit analysis as required by the Commodity Exchange Act. The plaintiffs argued that the CFTC failed to demonstrate that additional regulation of investment companies was necessary in light of the SEC's extensive regulatory regime to which mutual funds are already subject. They also asserted that the CFTC did not adequately consider the substantial costs imposed on the mutual fund industry by these regulations.

The district court rejected the plaintiffs' arguments. With emphasis on the "'more robust mandate' after Dodd-Frank 'to manage systemic risk and to ensure safe trading practices by entities involved in the derivatives markets,'" the court found that the CFTC provided reasoned justification for the Amended Rule. This included the need to eliminate "informational 'blind spots'" in the derivatives markets and the CFTC's concern about "in-name-only" mutual funds that were operating as *de facto* unregulated commodity pools.[1] The court agreed with the CFTC that the Amended Rule effectuates the congressional purposes of Dodd-Frank "to provide more transparency and regulatory oversight of derivatives trading generally." The court concluded that the link between unregulated derivatives trading and the 2008 financial crisis provided a rational basis for the CFTC to reinstate and augment its previously revoked trading thresholds and marketing restrictions as a requirement for exemption under Rule 4.5.

The court also rejected the argument that the CFTC was not in a position to evaluate the costs imposed on the mutual fund industry by subjecting registered investment companies to dual and potentially conflicting obligations of the CFTC and the SEC. The court was unconvinced by the plaintiffs' argument that the Amended Rule is too burdensome and noted that the "SEC itself had acknowledged that 'it had not developed a comprehensive and systematic approach to derivatives related issues.'" The court considered the Harmonizing Amendments and the plaintiffs' criticisms of what they deemed a "regulate-first and harmonize-later approach," but found that the CFTC's decision to proceed with certain aspects of the Amended Rule, while completing the harmonization process, was neither arbitrary nor capricious.

Implications for Registered Investment Companies and Their Advisers

The decision represents a departure from recent decisions by the U.S. Court of Appeals for the D.C. Circuit in which agencies were found to have failed to adequately assess the economic effects of their proposed rulemaking.[2] Notably, the recent tendency to subject new regulations to more exacting review had generated a degree of optimism about the plaintiffs' chances of success in this case. Indeed, a CFTC commissioner had issued a dissent to the Amended Rule and opined that "[i]t is unlikely… that the cost-benefit analysis supporting the rules will survive judicial scrutiny if challenged."[3] Nevertheless, the result in this case is consistent with the broader principle that federal courts are typically reluctant to second-guess an administrative agency's judgment calls, and the standard of review that applies to judicial review of agency rulemaking is highly deferential. As of the date of this alert, the plaintiffs had not announced whether they intend to appeal the district court's decision.

Operators (typically the principal investment advisers) of registered investment companies that do not qualify for the exclusion from registration under the Amended Rule will be required to register as CPOs by December 31, 2012 by becoming members of the NFA. However, as noted above, they will not have to comply with certain recordkeeping, reporting and disclosure requirements until 60 days following the

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[1] The latter justification was in reference to a registered investment company's use of commodity subsidiaries, a practice highlighted by the National Futures Administration in its June 2010 petition to the CFTC to revise Rule 4.5.
[2] *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).
[3] *See* Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators, Dissenting Statement of Commissioner Jill E. Sommers, 77 Fed. Reg. 11,343, 11,344 (proposed Feb. 24, 2012).

effectiveness of the Harmonizing Amendments. As the December 31, 2012 compliance date approaches, the court's decision refocuses industry attention on the inconsistencies between the CFTC and NFA disclosure and reporting obligations applicable to registered CPOs, on the one hand, and the SEC requirements to which registered investment companies and investment advisers are currently subject, on the other hand. The Harmonizing Amendments address some, but not all, of the potential conflicts between the overlapping regimes, and the CFTC has not announced when it expects to publish the final rule for the Harmonizing Amendments. Many in the industry believe that, as a practical matter, a delayed effective date for the final Harmonizing Amendments or a grace period longer than 60 days will be required. Absent guidance to the contrary, the disclosure requirements applicable to registered CPOs and the funds they manage may trigger a 485(a) post-effective amendment to funds' registration statements, which itself requires a 60-day filing period with the SEC, thus further extending the time needed to implement any wide-reaching disclosure revisions. Until the Harmonizing Amendments become final, the full impact on existing disclosure and reporting documents of registered investment companies that are required to register under CFTC rules remains unclear.

If you would like to learn more about the developments discussed in this Alert, please contact the Ropes & Gray attorney with whom you regularly work or any member of the Ropes & Gray Investment Management group listed below.

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