

**MEMO# 27332**

June 25, 2013

## **Court of Appeals Rules Against ICI and Chamber In Lawsuit Challenging Amendments to CFTC Rule 4.5**

[27332]

June 25, 2013

TO: ACCOUNTING/TREASURERS COMMITTEE No. 20-13  
BOARD OF GOVERNORS No. 11-13  
CLOSED-END INVESTMENT COMPANY MEMBERS No. 56-13  
COMPLIANCE MEMBERS No. 29-13  
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 51-13  
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 29-13  
ETF ADVISORY COMMITTEE No. 30-13  
FIXED-INCOME ADVISORY COMMITTEE No. 14-13  
ICI GLOBAL MEMBERS  
INTERNATIONAL MEMBERS No. 28-13  
INVESTMENT ADVISER MEMBERS No. 43-13  
INVESTMENT COMPANY DIRECTORS No. 13-13  
OPERATIONS MEMBERS No. 15-13  
SEC RULES MEMBERS No. 60-13  
SMALL FUNDS MEMBERS No. 39-13  
TRANSFER AGENT ADVISORY COMMITTEE No. 47-13  
UNIT INVESTMENT TRUST MEMBERS No. 16-13  
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 16-13 RE: COURT OF APPEALS  
RULES AGAINST ICI AND CHAMBER IN LAWSUIT CHALLENGING AMENDMENTS TO CFTC RULE  
4.5

On June 25, 2013, a three-judge panel of the United States Court of Appeals for the District of Columbia Circuit (Court) issued its ruling in the appeal by ICI and the U.S. Chamber of Commerce (appellants) challenging the Commodity Futures Trading Commission's (CFTC) amendments to Rule 4.5 under the Commodity Exchange Act (CEA). The Court rejected appellants' arguments and affirmed the grant of summary judgment by the United States District Court for the District of Columbia (District Court) in favor of the CFTC. The opinion is attached, and is summarized briefly below. [\[1\]](#)

The opinion, written by Senior Circuit Judge Sentelle, first provided a regulatory history of

Rule 4.5, and a discussion of the administrative process through which the rule was amended. The Court then addressed, and rejected, each of appellants' contentions in the appeal with the following explanations.

The Court addressed appellants' claim that the CFTC failed to explain the change in this rulemaking from the rationale offered for its 2003 amendments to Rule 4.5, which broadened the rule's exclusion. The Court concluded that the CFTC adequately addressed its change in policy and the more stringent requirements imposed under the recent amendments. The Court acknowledged appellants' argument that the CFTC had an obligation to address Rule 4.5's impact on liquidity, but noted that "the [Administrative Procedure Act] imposes no heightened obligation on agencies to explain 'why the original reasons for adopting the displaced rule or policy are no longer dispositive.'" The Court noted that, as long as a reviewing court can "'reasonably . . . discern[]' the agency's path, we must uphold the regulation, even if the agency's decision has 'less than ideal clarity.'" The Court found that amended Rule 4.5 "clears this low bar" and, that in amending the rule, the CFTC was responding to changed circumstances in the markets and a "congressional shift evidenced in the Dodd-Frank Act . . ."

The Court rejected appellants' argument regarding cost-benefit analysis, finding that the CFTC's explanations were adequate "to justify the marginal benefit of CFTC regulation of registered investment companies in the derivatives markets . . ." To support this conclusion, the Court cited, among other things, the CFTC's discussion of the recent concept release on derivatives issued by the Securities and Exchange Commission (SEC), in which the SEC stated that its staff had not developed a "comprehensive and systematic approach to derivatives related issues." The Court agreed with the District Court that the Court's prior decisions in the Business Roundtable and American Equity cases [\[2\]](#) were distinguishable from this case because here, the CFTC did consider whether investment companies were otherwise regulated and concluded further regulation was necessary. The Court found that the CFTC's efforts to harmonize SEC and CFTC regulations further distinguished this case from Business Roundtable and American Equity.

In discussing the CFTC's cost-benefit analysis, the Court stated that the CFTC "had no obligation to consider hypothetical costs that may never arise" and was not required "to measure the immeasurable." The Court noted, however, that the benefits on which the CFTC relied in adopting amended Rule 4.5 were not hypothetical, and that "if it should materialize that the harmonization in some fashion destroys those benefits, appellants would then be free to raise the resulting imbalance of costs and benefits in a challenge to the harmonization rule." The Court also found that, for purposes of the cost-benefit analysis, it was not arbitrary or capricious for the CFTC not to have defined "swap" at the time of the Rule 4.5 rulemaking, or to have refused to gather additional market data before amending Rule 4.5.

In response to appellants' claim that it was arbitrary and capricious for the CFTC to include swap transactions in amended Rule 4.5's registration threshold, the Court found that, while the CFTC's response offered "less than ideal clarity," it was sufficient under the law. The Court also rejected appellants' challenge to the definition of bona fide hedging under Rule 4.5, as well as the challenge to the five percent trading threshold under amended Rule 4.5.

Finally, the Court disagreed with appellants' contention that the CFTC failed to provide adequate opportunity for notice and comment. The Court found that the CFTC provided adequate notice of its cost-benefit analysis, and that the seven-factor marketing test in the release adopting amended Rule 4.5 was a "general statement of policy" to which the notice

and comment requirements of the Administrative Procedure Act do not apply.

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Senior Counsel

Rachel H. Graham  
Senior Associate Counsel

## [Attachment](#)

### **endnotes**

[1] More information relating to the lawsuit may be found on ICI's website at [http://www.ici.org/cftc\\_challenge](http://www.ici.org/cftc_challenge).

[2] See *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011); *American Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010).

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