

MEMO# 28402

September 24, 2014

Court Strikes Down Key Claims in Lawsuit on CFTC Cross-Border Guidance

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 61-14
REGISTERED FUND CPO ADVISORY COMMITTEE RE: COURT STRIKES DOWN KEY CLAIMS IN LAWSUIT ON CFTC CROSS-BORDER GUIDANCE

On September 16, the United States District Court for the District of Columbia (“Court”) issued a generally unfavorable ruling [\[1\]](#) in the lawsuit brought by the Securities Industry and Financial Markets Association (“SIFMA”), the International Swaps and Derivatives Association (“ISDA”), and the Institute of International Bankers (“IIB”) against the Commodity Futures Trading Commission (“CFTC”) related to the interpretive guidance and policy statement issued last year by the CFTC on the extraterritorial application of the swaps provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). [\[2\]](#) The opinion is summarized briefly below.

Background

Plaintiffs brought a lawsuit against the CFTC in December 2013 seeking vacatur of the Cross-Border Action on procedural and substantive grounds, partial vacatur of numerous Title VII rules, and an injunction to prevent the CFTC from applying those Title VII rules extraterritorially in the absence of a properly promulgated regulation addressing the rules’ extraterritorial application. Before addressing plaintiffs’ claims, the Court first provided background on the 2008 financial crisis as demonstrating a clear need for regulation of the over-the-counter derivatives markets, Title VII of the Dodd-Frank Act as providing the CFTC with the authority to regulate those markets (including the extraterritorial application of the provisions of Title VII in certain circumstances), and a discussion of the different categories of Title VII rules that the CFTC has adopted (clearing rules, transparency and competition rules, registration and compliance rules, risk control rules, and reporting rules). [\[3\]](#) The opinion also includes a detailed discussion of the content of the Cross-Border Action and the subsequent advisory issued by the CFTC’s Division of Swap Dealer and Intermediary Oversight regarding the applicability of transaction-level requirements to swap activity in the United States. [\[4\]](#)

Cross-Border Action

Plaintiffs claimed that the CFTC, when promulgating the Cross-Border Action, failed to

comply with the notice-and-comment rulemaking requirements of the Administrative Procedure Act (“APA”) and the cost-benefit analysis requirements of the Commodity Exchange Act (“CEA”). Plaintiffs also argued that the CFTC exceeded its authority to regulate extraterritorially under Section 2(i) of the CEA, and that the CFTC failed to provide satisfactory and consistent explanations for its choices as to the Title VII Rules’ extraterritorial applications to certain foreign entities or transactions.

In order to determine the applicable standard of review, the Court engaged in a lengthy analysis regarding whether the Cross-Border Action was a legislative rule, an interpretive rule, or a policy statement. It concluded that, with the exception of a four-page portion of the document, [5] the Cross-Border Action is a policy statement. In coming to this conclusion, the Court noted that the Cross-Border Action “is binding on neither the CFTC nor swaps market participants” and “does not ‘command[,]’ does not ‘require[,]’ does not ‘order[,]’ and does not ‘dictate[,]’” [6] The Court emphasized the conditional terms used in the Cross-Border Action and the case-by-case approach to application and enforcement discussed by the CFTC, stating that “no CFTC staff member or market participant could, after consulting the Cross-Border Action in its entirety, reasonably construe it as setting forth binding norms.” [7]

The Court disagreed with plaintiffs that the CFTC’s policy of substituted compliance, discussed in the Cross-Border Action, is a “safe harbor” indicative of a legislative rule, instead concluding that it “merely announced the agency’s ‘general framework for substituted compliance.’” [8] The Court also accorded weight to the CFTC’s characterization of the Cross-Border Action as “interpretive guidance and policy statement[s].” [9]

The Court stated that plaintiffs were unable to point to evidence that the CFTC has applied the Cross-Border Action as binding in practice, and noted that the CFTC has not applied the Cross-Border Action in a single enforcement action. The Court acknowledged that plaintiffs’ members may feel “pressure” to comply with the Cross-Border Action, but concluded that the industry’s “de facto compliance” is not enough “to convert the guidance into a binding rule” [10] and that the industry is “completely ‘free to ignore’” the Cross-Border Action “or—as they have to date—comply voluntarily.” [11]

Because the Court concluded that the Cross-Border Action is part policy statement and part interpretive rule, the Court determined that it was not subject to review under the APA, as it was not a “final agency action” at this time for purposes of the APA. The Court notes, however, that if and when the CFTC applies the Cross-Border Action in an enforcement action or lawsuit, it will be reviewable in the context of that action (“just as if the [Cross-Border Action] had never been issued”). [12]

Title VII Rules

Plaintiffs challenged the Title VII Rules on three grounds. According to the Court, they first argued that because the Title VII Rules do not define the scope of their extraterritorial applications, they have no extraterritorial reach. Second, they argued that by refusing to define the scope of the Title VII Rules’ extraterritorial applications in those rules, the CFTC failed “‘to consider an important aspect to the problem’ being regulated” and otherwise failed to respond adequately to significant public comments. Finally, plaintiffs argued that the CFTC failed to conduct an adequate cost-benefit analysis that considered the costs and benefits of the extraterritorial application of the Title VII Rules.

The Court rejected plaintiffs’ first two arguments, but agreed with plaintiffs’ third argument,

finding that the CFTC was required to consider adequately the costs and benefits of extraterritorial application for some of the Title VII Rules but failed to do so. Specifically, the Court stated that the CFTC’s “complete failure to address the extraterritorial costs and benefits—let alone to acknowledge the lack of data or identify concomitant uncertainties—renders its cost-benefit analyses arbitrary and capricious.” [13] The Court stated, however, that the CFTC did not have an obligation to consider the costs of duplicative regulation relating to foreign regulation because foreign regulations were not finalized at the time of the Title VII Rulemakings, and therefore the costs of any duplicative regulation were hypothetical (although it may need to consider such costs on remand).

The Court consequently remanded ten of the Title VII Rules to the CFTC and ordered the CFTC to conduct the required cost-benefit analysis with respect to the extraterritorial application of those rules. [14] The Court explained that it was not requiring that the rules be vacated while the CFTC conducted new cost-benefit analysis because doing so “would be unnecessarily disruptive to the CFTC’s mission and the purposes of the Dodd-Frank Act.” [15] In remanding the rules, however, the Court stated its belief that the CFTC was likely to reach the same result with respect to these rules after complying with its cost-benefit obligations. The Court further noted that the CFTC “would only need to make explicit” which of the benefits and costs applicable in the domestic context also apply with respect to the Rules’ extraterritorial applications.” [16] The Court noted that its standard of review with respect to the CFTC’s cost-benefit analysis of these rules will be “particularly deferential” and that there is “at least a ‘serious possibility’ . . . that after remand the CFTC will repromulgate Title VII Rules containing the same substantive requirements.” [17]

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endnotes

[1] Securities Industry and Financial Markets Association, et al., v. United States Commodity Futures Trading Commission, No. 13-CV-1916 slip.op. (D. D.C.) (Sept. 16, 2014), available at https://ecf.dcd.uscourts.gov/cgi-bin/show_public_doc?2013cv1916-58 (opinion); https://ecf.dcd.uscourts.gov/cgi-bin/show_public_doc?2013cv1916-59 (order).

[2] Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013) (“Cross-Border Action”).

[3] The plaintiffs challenged 14 Title VII rules (the “Title VII Rules”) within these categories, as described by the Court: clearing rules (the Clearing Determination Rule and the Straight-Through Processing Rule); transparency and competition rules (the Real-Time Reporting Rule, the SEF Registration Rule, and the Trade Execution Rule); registration and compliance rules (the Entity Definition Rule and the Swap Entity Registration Rule); risk control rules (the Daily Trading Records Rule, the Risk Management Rule, the Chief Compliance Officer Rule, and the Portfolio Reconciliation and Documentation Rule), and reporting rules (the SDR Reporting Rule, the Historical SDR Reporting Rule, and the Large Trader Reporting Rule).

[4] CFTC Letter No. 13-69 (Nov. 14, 2013), available at <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/13-69.pdf>.

[5] The Court concluded that the section of the Cross-Border Action entitled “Interpretation of Section 2(i)” is an interpretive rule.

[6] Opinion, *supra* note 1, at 58 (internal quotations omitted).

[7] *Id.* at 59.

[8] *Id.* at 61.

[9] *Id.* at 63.

[10] *Id.* at 66.

[11] *Id.* at 67.

[12] *Id.* at 72.

[13] *Id.* 84-85.

[14] These Title VII Rules are: the transaction-level Real-Time Reporting, Daily Trading Records, and Portfolio Reconciliation and Documentation Rules, and the entity-level Entity Definition, Swap Entity Registration, Risk Management, Chief Compliance Officer, SDR Reporting, Historical SDR Reporting Rules, and SEF Registration Rules. Plaintiffs’ claims as to the Trade Execution Rule were dismissed, and the Court ruled in favor of the CFTC with respect to plaintiffs’ claims regarding the Large Trader Reporting, Straight-Through Processing, and Clearing Determination Rules.

[15] Opinion, *supra* note 1, at 90.

[16] *Id.* at 88.

[17] *Id.* at 89.