

**MEMO# 26588**

October 16, 2012

## **CFTC Files Supplemental Brief in Lawsuit Challenging Amendments to Rule 4.5**

[26588]

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TO: BOARD OF GOVERNORS No. 11-12  
CLOSED-END INVESTMENT COMPANY MEMBERS No. 65-12  
COMPLIANCE MEMBERS No. 16-12  
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 56-12  
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 35-12  
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SMALL FUNDS MEMBERS No. 33-12  
UNIT INVESTMENT TRUST MEMBERS No. 9-12  
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 14-12 RE: CFTC FILES  
SUPPLEMENTAL BRIEF IN LAWSUIT CHALLENGING AMENDMENTS TO RULE 4.5

During the recent oral argument in the lawsuit brought by ICI and the U.S. Chamber of Commerce against the Commodity Futures Trading Commission (CFTC), Judge Beryl Howell noted that the recent decision by Judge Robert Wilkins invalidating the CFTC's position limits rule (ISDA decision) [\[1\]](#) could have implications for ICI's lawsuit because Rule 4.5 cross-references definitions of "bona fide hedging" included in the now-invalidated position limits rule. The parties offered to submit supplemental briefs on the implications of the invalidation of the position limits rule for the definitions of bona fide hedging used in Rule 4.5. The CFTC filed its brief with the court yesterday, along with a "clarification" regarding a statement its counsel made at the oral argument. These documents are attached and are summarized below. ICI's brief is due to the court on October 22.

In the brief, the CFTC focuses on the language in Rule 4.5 that, in determining eligibility for exclusion from the definition of commodity pool operator, a registered investment company need not count any position used "for bona fide hedging purposes within the meaning and intent of rules 1.3(z)(1) and 151.5" (the definitions of bona fide hedging that were included in the position limits rule and invalidated as part of the ISDA decision). The CFTC acknowledges that the ISDA decision vacated and remanded the position limits rule in its

entirety, and made no exception for the definitions of bona fide hedging included in the rule. The CFTC goes on to describe, however, the interpretation that its staff issued last Friday of bona fide hedging for purposes of amended Rule 4.5. [2] That interpretation, which is attached to this memorandum, was explicitly intended to address the invalidation of the position limits rule as it affects amended Rule 4.5. In the interpretation, the CFTC staff takes the view that, in promulgating amended Rule 4.5, the CFTC intended to incorporate the substance of the two definitions of bona fide hedging that were vacated by the ISDA decision, independently of whether those definitions remain effective in connection with the position limits rule. As a result, the CFTC concludes that “the ISDA decision will not impact the operation of amended Rule 4.5.”

The CFTC also filed a “clarification” regarding the alternative net notional test. At the oral argument, the CFTC’s counsel, Jonathan Marcus, stated that the alternative net notional test included in amended Rule 4.5 “exempts registered investment companies from the requirement to register unless their commodity derivative investments place at risk more than 100 percent of the total value of the fund in question.” Eugene Scalia, counsel to ICI and the Chamber, objected that such a characterization is not necessarily true. In the notice of clarification, the CFTC states that “[i]t would be more precise to say that the 100-percent test is designed to include within the definition of ‘commodity pool operator’ only entities with significant exposure to the commodity derivative markets.”

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#### [Attachment](#)

#### **endnotes**

[1] International Swaps and Derivatives Association, et al. v. United States Commodity Futures Trading Commission, Case No. 11-cv-2146 (D.D.C. September 28, 2012).

[2] Division of Swap Dealer and Intermediary Oversight, Interpretation of Bona Fide Hedging in Commission Regulation 4.5: Restatement of Terms Incorporated by Reference, CFTC Letter No. 12-19 (October 12, 2012).