Securities Regulation Daily Wrap Up, TOP STORY—D.D.C.: CFTC gets partial swaps rules win, must do cost-benefit analysis of Title VII rules, (Sep. 16, 2014)

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By Mark S. Nelson, J.D.

The federal district court in Washington, D.C. today gave the CFTC a partial victory in its battle to defend its Dodd-Frank Act swaps rules against a broad legal challenge led by three swaps industry trade groups on behalf of their members. The court also declined to vacate certain rules or issue other injunctive relief asked for by the trade groups. But already it seems clear that the CFTC will need to engage in more detailed cost-benefit analysis of some of the challenged rules (*Securities Industry And Financial Markets Association, et al. v. CFTC*, September 16, 2014, Friedman, P.).

The court granted the CFTC's request to dismiss a challenge by the Securities Industry And Financial Markets Association (SIFMA), the International Swaps and Derivatives Association (ISDA), and the Institute of International Bankers (IIB) to the agency's trade execution rule because the trade groups lacked standing to dispute the rule's extraterritorial application. The court also granted summary judgment for the CFTC regarding its cross-border action, large trader reporting, straight-through processing, and clearing determination rules.

CFTC Chairman Timothy G. Massad said he plans to continue the agency's swaps reform effort in order to focus on Congressional worries about how overseas risks can impact U.S. markets. The swaps trade groups filed their suit against the CFTC last December and Chairman Massad inherited the swaps litigation from prior CFTC Chairman Gary Gensler, who led the agency's Dodd-Frank Act rulemakings during his tenure until earlier this year.

"I am pleased the court upheld the Commission's July 2013 policy statement on the cross-border application of Title VII swaps provisions, and rejected a sweeping injunction of the rules that are at the heart of Dodd-Frank's overhaul of the swaps markets," said Massad.

As of publication, SIFMA, ISDA, and IIB had not issued any formal statements on the district court's opinion.

Associational standing. The CFTC had disputed whether any of the trade groups' members would have standing to challenge the cross border action and Title VII rules if they sued on their own. The court quickly decided that related worries did not exist about whether the trade groups' suit was aimed at interests "germane" to their purposes and whether any of their members would have to participate in the suit.

As a result, the trade groups have standing if, for each challenged rule, one of their members is regulated by or directly harmed by one of the rules. The court assumed, for purposes of its standing analysis, that the cross-border action is a binding legislative rule (as the trade groups requested), which means that standing to challenge the extraterritorial application of any Title VII rule results in standing to challenge the cross border action. The court would later find that, in another context, the cross-border action was not a legislative rule.

The trade groups claimed associational standing via two of their foreign members, the French company Société Générale (SG), and the German company Deutsche Bank AG (Deutsche Bank). Both companies are registered swap dealers and must comply with rules related to the CFTC's "U.S. persons" definition. The court said the trade groups have standing via SG and Deutsche Bank to contest the CFTC's cross-border action and certain Title VII transaction-level rules. But the court said the CFTC cannot assert lack of traceability or redressability by saying it would enforce the Title VII rules even if the cross-border action did not exist.

The trade groups also asserted standing to contest the CFTC's SEF registration rule because some foreign SEFs denied SG's and Deutsche Bank's U.S. employees access to swaps platforms due to the risk this access may trigger the CFTC's rules. Relying on D.C. Circuit law, the court said the extraterritorial application of the CFTC's rule was the "substantial factor" in SG and Deutsche Bank not gaining access to relevant platforms. This factor was sufficient to confer standing on the trade groups regarding the SEF registration rule.

But the court said the trade groups lack standing via SG and Deutsche Bank as to the CFTC's trade execution rule. The court explained that this rule states key factors for determining if a swap is "available to trade" and yet it is a statutory requirement that mandates execution of "available to trade" swaps on a SEF or DCM. According to the court, the trade groups did not allege that the trade execution rule triggers the statutory requirement to yield more "available to trade" determinations for SG or Deutsche Bank, which could be a substantial factor conferring standing if evidence of this extraterritorial application of the CFTC's rule to foreign SEFs and DCMs existed.

As for the U.S.-based members of the trade groups, the court said standing is less obvious because these companies get pulled into the CFTC's extraterritorial application of its rules only via their foreign affiliates. For example, Goldman Sachs & Co.'s foreign conduits, and J.P. Morgan Securities LLC's and JPMorgan Chase & Co.'s (collectively JPMorgan) J.P. Morgan Securities plc affiliate would be the relevant entities for purposes of standing.

The trade groups claimed the so-called shareholder standing rule (*i.e.*, a parent corporation cannot sue on behalf of its subsidiary) was inapt regarding their formal U.S.-based members. The court said this view was wrong and, thus, rejected arguments that the trade groups' formal U.S. members shared regulatory burdens from the CFTC's entity-level Title VII rules across their corporate families, had to re-work how they do business with their affiliates, or served as "membership associations" to represent corporate family interests.

With respect to the trade groups' U.S.-based members' foreign affiliates, the court applied the "indicia of membership" test. Specifically, the court said JPMorgan's British affiliate, J.P. Morgan Securities plc, bore indicia of membership in SIFMA and ISDA because it enjoyed the benefits of membership and engaged in the decision-making activities of these groups, despite its absence from both groups' membership rolls.

Ripeness issues. The trade groups made both procedural and substantive claims about the CFTC's cross-border action. Procedurally, they said the CFTC violated the Administrative Procedure Act (APA) by neglecting notice and comment mandates and by failing to do enough cost-benefit analyses of its rules. Substantively, the trade groups said the CFTC exceeded its authority under Commodity Exchange Act (CEA) §2(i) and gave inconsistent rationales for many of its decisions on rules for foreign entities and transactions.

As a starting point, the court found the trade groups' procedural claims were ripe for review because they involve purely legal questions without any need for more factual development of the issues. But the court initially doubted that the trade groups' substantive claims could go forward because the CFTC has not yet tried to enforce the cross-border action. Still, the court invoked an exception to prudential ripeness and opted not to decide this jurisdictional question. The court, however, said in a footnote that had the CFTC and the trade groups agreed with the court's later findings on the cross-border action's policy and interpretive aspects, the trade groups' substantive claims would be unripe.

Statement has split personality. The court next characterized the CFTC's cross-border action as mostly a policy statement, but four pages of the statement bear the features of an interpretive rule. The trade groups had argued that the cross-border action is a legislative rule, while the CFTC countered that it is a policy statement, but conceded that some of the statement could be interpretive.

The court said that despite the possibility of future enforcement based on the CFTC's cross-border action, swaps market participants can ignore it or voluntarily comply with its admonitions. The court also noted that the cross-border action is not facially binding, states the CFTC's "tentative" views, is referred by the CFTC as a policy, was classified by the CFTC (both proposed and final versions) as interpretative and policy statements, was not published in the Code of Federal Regulations, does not invoke the CFTC's general rulemaking authority, and does not effectively amend prior legislative rules.

The court also noted that the CFTC's general counsel told the Commission just before it adopted the cross-border action that the statement was not enforceable. Since it adopted the statement, the CFTC has used only its statutory authorities to enforce the extraterritorial application of its Title VII rules.

Moreover, the court rejected numerous arguments pressed by the trade groups. For one, references to the CFTC's substituted compliance regime did not amount to a safe harbor that would make the cross-border action

a legislative rule. Likewise, the trade groups' effort to "cherry pick" mandatory-sounding language from the cross-border action were unavailing, as was the trade groups' claim that the CFTC's statement's was too long and intricate to be a mere policy statement. The court also rejected the trade groups' claim that the CFTC's statement was a "charade" designed to evade judicial review.

Said the court: "Because the majority of the Cross-Border Action looks, walks, and quacks like a policy statement, the Court holds that the majority of the Cross-Border Action is a policy statement."

But the court said four of the nearly 80 pages of text in the cross-border action consisted of an interpretive rule. These passages, said the court, express the CFTC's "construction" of the text within CEA §2(i), which the court said is typical of an interpretation. As a result, the four-page section of the cross-border action gives it a dual nature that is simultaneously an agency policy statement and an interpretive rule.

Still, the court warned that the cross-border action may eventually become reviewable under the APA. Specifically, the court told the CFTC to be ready to defend the cross-border action if it ever uses it in an enforcement action or other law suit.

Cost-benefit analysis on remand. But the trade groups won their challenge to many the CFTC's other swaps rules, which the court remanded to the agency for new cost-benefit analysis. Specifically, the court said the CFTC's rules were arbitrary and capricious due to the agency's failure to do enough cost-benefit analysis. Judge Friedman, though, rejected the trade groups' arguments that the CFTC failed to define the scope of these rules' extraterritorial application, or that the agency failed to mull the "problem" to be "regulated" or did not review public comments.

The court rejected the trade groups' argument that the CFTC had to define the reach of CEA §2(i) by rule. The court said this statutory provision clearly shows Congressional intent that it apply extraterritorially, if the required jurisdictional nexus exists. The court also said a federal agency is free to opt for a general rule or an ad hoc approach, especially if the agency must deal with new subject matter that may counsel against a "rigidif[ied]" approach. The Dodd-Frank Act's language regarding the addition of CEA §2(i) does not require the CFTC to adopt an implementing regulation, which means the CFTC can take a case-by-case view instead of conducting a rulemaking.

Moreover, the court said the CFTC did not act arbitrarily or capriciously in opting not to deal with the extraterritorial application of its Title VII rules, in that rulemaking. The court said the CFTC need not deal with the scope of each rule within Title VII, nor must the agency give up its freedom to address some, but not all, possible issues in a rulemaking. Nor did the CFTC have to reply to public comments that were beyond the scope of its Title VII rulemaking.

But the court said many of the CFTC's Title VII rules flunked the "not particularly demanding" cost-benefit analysis required by CEA §15(a) because the agency failed to "consider" and "evaluate" the costs and benefits of these rules' extraterritorial application. The court rejected the CFTC's claim that no cost-benefit analysis of the extraterritorial application of the rules was needed because Congress made the relevant law applicable beyond domestic U.S. markets. The court said this is a key reason for mandating cost-benefit analysis, while distinguishing the D.C. Circuit's opinion in the suit over the SEC's conflict minerals rule, in which the appeals court there said the SEC could rely on Congress's judgment that the costs of that agency's rule were necessary and appropriate.

The court, however, agreed with the CFTC on one point about cost-benefit analysis of the Title VII rules. The CFTC had argued that it could not account for the costs of potentially duplicative swaps rules around the world because the CFTC was far ahead of other countries in developing its swaps regime. The court said the possibly duplicative costs at that time were "hypothetical" and the CFTC properly did not consider them.

CFTC swaps rules affected by the court's remand include 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 the SEF registration rules.

The case is No. 13-1916.

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Companies: Securities Industry And Financial Markets Association; International Swaps and Derivatives Association; Institute of International Bankers; Société Générale; Deutsche Bank AG; Goldman Sachs & Co.; J.P. Morgan Securities LLC; JPMorgan Chase & Co.; J.P. Morgan Securities plc

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