Funds and the Derivatives Markets: Recent Developments and Ongoing Challenges*

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M. Holland West and Philip T. Hinkle**

Dechert LLP

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** Holland West (New York) and Phil Hinkle (Washington D.C.) focus on public and private fund, commodity, and derivative transaction and regulatory matters. Assistance provided by Caroline M. Richardson (New York) and Matthew S. Virag (New York).

Authors

M. Holland West
Partner
New York: +1 212 698 3527
holland.west@dechert.com

Philip T. Hinkle
Associate
Washington: +1 202 261 3460
philip.hinkle@dechert.com

Matthew Virag
Associate
New York: +1 212 641 5695
matthew.virag@dechert.com

Caroline M. Richardson
Associate
New York: +1 212 641 5674
caroline.richardson@dechert.com

Contributors

Abigail Bell
Partner
London: +44 20 7184 7443
abigail.bell@dechert.com

Daniel Deacon
Associate
London: +44 20 7184 7378
daniel.deacon@dechert.com

Victor M. Bieger
Associate
New York: +1 212 649 8732
victor.bieger@dechert.com

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I. INTRODUCTION AND OVERVIEW OF DODD-FRANK TITLE VII

Title VII of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Title VII" or "Dodd-Frank"), enacted on July 21, 2010, provided for the first time a comprehensive regulatory framework for the over-the-counter ("OTC") derivatives markets. Fundamentally, Title VII aimed to prevent future financial crises by mandating robust market and transaction level transparency while reducing structural leverage and systemic risk throughout the derivatives markets.

Title VII codified the global de-risking process underway since the 2008-2009 financial crisis with particular focus on:

- reducing counterparty risk and enhancing transparency and price discovery by requiring clearing and exchange trading of eligible derivatives contracts;

- deleveraging the OTC derivatives markets by imposing new regulatory capital and margin requirements on OTC swap dealers ("SDs") and security-based swap dealers ("SBSDs") and on certain OTC major swap participants ("MSPs") and major security-based swap participants ("MSBSPs");

- requiring SDs, SBSDs, MSPs, and MSBSPs to register with the U.S. Securities and Exchange Commission ("SEC") and/or the U.S. Commodity Futures Trading Commission ("CFTC") and to continuously disclose detailed information regarding their derivatives trading activities; and

- prohibiting U.S. Federal guarantees and other Federal assistance from being provided to insured depository institutions involved in the swap markets, subject to exceptions for affiliated SDs and certain swap activities related to *bona fide* hedging and traditional bank activities.

Certain portions of Title VII remain subject to further rulemaking by the SEC and the CFTC. This outline reviews various developments under Dodd-Frank relating to swaps and other derivatives applicable to U.S. mutual funds, as well as other funds and market participants, that trade in swaps. **This outline is current as of its publication date specified on the cover page, and it has not been updated or supplemented since then.**

II. JURISDICTION

(a) SEC and CFTC Jurisdiction over the Derivatives Markets

Dodd-Frank allocated jurisdiction over the derivatives markets between (i) the SEC under the U.S. Securities Act of 1933 as amended ("Securities Act") and the U.S. Securities Exchange Act of 1934 as amended ("Exchange Act") for "security-based swaps" and certain participants in the security-based swap markets and (ii) the CFTC under the U.S. Commodity Exchange Act as amended ("CEA") for all other "swaps" and certain participants in the swaps markets. The SEC is the regulatory authority responsible for imposing requirements on security-based swaps, such as equity swaps and options. The CFTC has analogous authority over all swaps other than security-based swaps, such as commodity swaps, forwards, and options (in addition to futures contracts, options on futures, and commodity options, which are already regulated by the CFTC).

(b) Derivatives Contracts that are Commodities vs. Securities

The following chart identifies broad categories of transactions that are "commodity interests"[1] subject to CFTC jurisdiction and "securities"[2] subject to SEC jurisdiction.

Financial Product	Commodity	Security
Commodity futures, including security futures (on single stocks, narrow-based security indices,[3] and broad-based security indices)	X	
Options on commodities	X	
Options on commodity futures	X	
Options on securities that settle into the security		X
Options on security futures that settle into a futures contract	X	
Swaps on individual securities or narrow-based security indices		X
Swaps on broad-based security indices	X	
Swaps on a single non-security loan[4]		X
Swaps on more than one non-security loan	X	
Swaps on a single loan that qualifies as a security		X
Swaps on 9 or fewer loans that qualify as securities		X

(c) Swaps vs. Non-Swaps

Dodd-Frank broadened the definition of "swap" and placed swaps not subject to SEC jurisdiction under CFTC jurisdiction. The charts below provide examples of swaps and non-swaps under CEA Section 1a(47) and the CFTC regulations thereunder.

Financial Product	Swap	Non-Swap
Foreign Exchange ("FX") Products:		
FX Forwards[5]		X
FX Swaps[6]		X
FX Currency Options	X	
Retail FX Currency Options		X
Non-Deliverable Forward Contracts ("NDFs") Involving FX	X	

1 CEA Section 4m(3)(C); CFTC Regulation 1.3(yy).

2 Securities Act Section 2(a)(1); Exchange Act Section 3(a)(10).

3 A narrow-based security index generally contains nine or fewer component securities (among other attributes). CEA Section 1a(35)(A)(i); Exchange Act Section 3(a)(55)(B)(i).

4 *See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule*, 77 Fed. Reg. 48208, 48266 n.662 (Aug. 13, 2012) ("Depending on the facts and circumstances loans may be notes or evidences of indebtedness that are securities.") (citing Exchange Act Section 3(a)(10)). A security-based swap is defined in CEA Section 1a(42) and Exchange Act Section 3(a)(68).

5 Under CEA Section 1a(24), an FX forward is narrowly defined as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange."

6 Under CEA Section 1a(25), an FX swap is narrowly defined as "a transaction that solely involves—(A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (B) a reverse exchange of [those] 2 currencies . . . at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange."

Financial Product	Swap	Non-Swap
FX Currency Swaps and Cross-Currency Swaps	X	
FX Options Traded on a National Securities Exchange		X
Forward Rate Agreements	X	
Combinations and Permutations:		
"Swaptions"	X	
Forward Swaps	X	
Mixed Swaps[7]	X	
Contracts for Differences:[8]		
On individual securities or narrow-based security indices		X
On commodity interests, including broad-based security indices	X	

Although not generally regulated as swaps, certain non-swaps (including physically-settled FX swaps and FX forwards) are subject to the CFTC's business conduct, regulatory reporting, anti-fraud, and anti-manipulation rules as well as the CFTC's existing jurisdiction over retail transactions.[9]

In addition, the following transactions, except for certain guarantees of swaps as described below, fall outside of the definitions of swap and security-based swap and are thus not regulated by the CFTC or the SEC.

Financial Product	Additional Information	Swap	Non-Swap
Guarantees of Swaps	Considered swaps to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position.	X	
Insurance Products	Must meet "Product Test"[10] and "Provider Test"[11] to be considered insurance and not swaps. Those products listed as "Traditional Insurance Products" must be provided in accordance with the Provider Test.		X

7 Under CEA Section 1a(47)(D), a "mixed swap" is a security-based swap that is also "based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence . . . ."

8 Careful analysis of the underlying item is necessary to categorize a contract for differences as a commodity interest or as a security.

9 *Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act; Final Determination*, 77 Fed. Reg. 69694, 69699 (Nov. 20, 2012); CEA Sections 1a(47)(E)-(F).

10 To satisfy the Product Test:

- the beneficiary of the agreement, contract, or transaction must carry the risk of loss with respect to an insurable interest continuously throughout the duration of the agreement, contract, or transaction;
- the agreement, contract, or transaction must require a proof of loss and limit any payment or indemnification to the value of the insurable interest;
- the agreement, contract, or transaction cannot be traded, separately from the insured interest, on an organized or OTC market; and

Financial Product	Additional Information	Swap	Non-Swap
Consumer Transactions	Customary transactions that are not typical derivatives transactions entered into by consumers (natural persons) as principals (or by their agents) primarily for personal, family, or household purposes.		**X**
Commercial Transactions	Customary business arrangements that are not typical derivatives transactions whether or not involving a for-profit entity.		**X**
Loan Participations	Purchaser acquiring a current or future direct or indirect ownership interest in the related loan or commitment.		**X**
Forward Contracts in Nonfinancial Commodities	Commercial market participants that regularly make or take delivery of the referenced commodity through a separately negotiated agreement.		**X**

III. IMPLEMENTATION AND RELATED ISSUES

Currently, the CFTC has adopted most of the rules mandated by Dodd-Frank. The CFTC's relevant substantive requirements are discussed in more detail below.

The SEC has not yet adopted most of its substantive rules relating to security-based swaps, although the SEC has stated that more of such rules will be proposed or finalized in the near future. When the SEC adopted its final rules on certain aspects of cross-border security-based swap activities ("SEC Cross-Border Rules"),[12] the SEC stated that its requirements relating to mandatory clearing, trade execution, regulatory reporting, and public dissemination will be addressed in future SEC rulemakings.

- with respect to financial guaranty insurance policies only, any acceleration of payment must be at the sole discretion of the provider.

CFTC Regulation 1.3(xxx)(4)(i)(A); Exchange Act Rule 3a69-1(a)(1).

11 To satisfy the Provider Test, an agreement, contract, or transaction must be:

- provided by a person subject to supervision by either the insurance commissioner of any state or the United States, and applicable state or federal law must regulate any such agreement, contract, or transaction as insurance;
- directly or indirectly issued by the United States, any state, or any of their respective agencies, instrumentalities, or pursuant to a statutorily authorized program thereof;
- for reinsurance only, issued by a person to another "eligible provider," so long as (i) the person offering reinsurance is not prohibited from doing so by applicable state or federal laws, (ii) the reinsurance agreement, contract, or transaction passes the Product Test or is an "Enumerated Product," and (iii) the total amount reimbursable by all reinsurers does not exceed the claims or losses paid by the person transferring the risk to the reinsurer, except as permitted under applicable state law; or
- for non-admitted insurance only, issued by a person who (i) is located outside the United States and is listed on the "Quarterly Listing of Alien Insurers," or (ii) meets the eligibility criteria for non-admitted insurers under applicable state law.

CFTC Regulation 1.3(xxx)(4)(i)(B); Exchange Act Rule 3a69-1(a)(2).

12 *Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to*

(a) Overview of CFTC Rulemaking

Certain regulations promulgated by the CFTC under Dodd-Frank can be conceptually divided into (i) "entity-level" requirements which apply to certain market participants without distinction as to the counterparty or location of the swap, and (ii) "transaction-level" requirements that apply to each swap. Notably, while most of the entity-level requirements apply to SDs (*e.g.*, the Business Conduct Rules, described below), many require elections and/or representations by their counterparties.

- "Entity-Level Requirements" relate to: (i) capital adequacy; (ii) chief compliance officer; (iii) risk management; (iv) swap data recordkeeping; (v) swap data reporting; and (vi) physical commodity swap reporting (*i.e.*, swap large trader reporting[13]).

- "Transaction-Level Requirements" relate to: (i) clearing and swap processing; (ii) margining (and segregation) for uncleared swaps; (iii) trade execution; (iv) trade relationship documentation; (v) portfolio reconciliation and compression; (vi) real-time public reporting; (vii) trade confirmation; (viii) daily trading records; and (ix) external business conduct standards ("Business Conduct Rules").

(b) Business Conduct Rules

The Business Conduct Rules include requirements that SDs and MSPs: (i) verify that their counterparties are "eligible contract participants" ("ECPs");[14] (ii) disclose material information to enable their counterparties to asses material risks, characteristics, incentives, and conflicts of interest; (iii) provide daily mid-market valuations for uncleared swaps; (iv) notify counterparties of their rights relating to clearing; (v) communicate with their counterparties in a fair and balanced manner based on principles of good faith and fair dealing; and (vi) provide additional information to "Special Entities," such as governmental entities, pension plans, and endowments.

(c) Mandatory Clearing of Swaps

(i) Clearing Requirement and Submission of Swaps for Clearing

Title VII amended the CEA to require clearing of all swap transactions that are acceptable to a derivatives clearing organization ("DCO") for clearing, other than any swap for which one of the counterparties is a commercial end-user.[15] The CFTC has adopted Regulation 50.2 to implement the CEA clearing

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Cross-Border Security-Based Swap Activities; Final Rule, 79 Fed. Reg. 39068 (Jul. 9, 2014) (adopting Rule 3a71-3(a)(4) under the Exchange Act, among other rules). *See* Section IV(b) herein.

13 If a fund is trading on U.S. reportable markets (designated contract markets ("DCMs") or swap execution facilities ("SEFs")) or trading "paired swaps", the fund will need to provide its futures commission merchants ("FCMs") and/or SDs, as applicable, with certain information in order to permit the FCMs to submit ownership and control reports ("OCRs") to the CFTC on CFTC Forms 102A, 102B, and 102S. The information may be provided through an electronic portal called FIA Tech OCR Portal. The earliest reports will be required in February 2015; however, industry participants are being encouraged to provide the information earlier to permit test filings.

14 An ECP is an entity classified by the CFTC as such based upon its regulated status or amount of assets. Financial institutions, investment companies subject to regulation under the U.S. Investment Company Act of 1940 as amended ("Investment Company Act"), commodity pools with assets over $5 million formed and operated by a person subject to regulation under the CEA or a foreign person performing a similar role or function subject as such to foreign regulation, and entities with assets over $10 million are all ECPs under the CFTC definition. CEA Section 1a(18).

15 CEA Section 2(h)(1)(A), (7)(A).

requirement. Timing of any clearing obligation depends on (i) authorization of clearinghouses, and (ii) authorization of products for clearing. Currently, there are 14 registered DCOs (*i.e.*, clearinghouses) and one more pending.

The CFTC is required to designate products as subject to mandatory clearing (i) in response to requests by DCOs with respect to products currently cleared by such DCOs, and/or (ii) on its own initiative.[16]

- A DCO must submit to the CFTC for prior approval any group, category, type, or class of swaps the DCO seeks to clear.[17] The CFTC is required to respond to any such DCO request within 90 days of submission of the request.[18]

- Additionally, the CFTC is required to review swaps that have not been accepted for clearing by a DCO on an ongoing basis, and may determine on its own initiative that such swaps should be required to be cleared.[19]

In making these determinations, the CFTC will review all relevant facts and circumstances, issue a public report containing the results of the determination, and take any action the CFTC determines necessary and in the public interest.[20] To be cleared, a product must be on standard terms, trade in volume, and be sufficiently liquid.

(ii) Categories of Swaps Subject to Mandatory Clearing

The CFTC made its first mandatory clearing designations on November 28, 2012 and determined that certain interest rate swaps and certain credit default swaps are subject to mandatory clearing.[21] Current designations include:

- Interest Rate Swaps ("IRS"): Basis Swaps, Fixed-to-Floating Swaps, and Forward Rate Agreements in U.S. Dollars, Euro, Pounds Sterling, and Japanese Yen, and Overnight Index Swaps in U.S. Dollars, Euro, and Pounds Sterling.[22]

- Credit Default Swaps ("CDS"): Untranched CDS on CDXNA.IG and CDXNA.HY North American Indexes and iTraxx Europe, iTraxx Europe Crossover, and iTraxx Europe HiVol.[23]

At its October 9, 2014 meeting, members of the CFTC's Global Markets Advisory Committee indicated that the next mandatory clearing designations to be made will relate to certain currency transactions. Specifically, the Committee members stated that the CFTC is considering issues surrounding the clearing of NDFs involving FX.

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16 CEA Section 2(h)(2).

17 CEA Section 2(h)(2)(B)(i); CFTC Regulation 39.5(b).

18 CEA Section 2(h)(2)(C); CFTC Regulation 39.5(b)(6).

19 CEA Section 2(h)(2)(A); CFTC Regulation 39.5(c).

20 CFTC Regulation 39.5(c)(3)(i)-(iii).

21 *Clearing Requirement Determination Under Section 2(h) of the CEA; Final Rule,* 77 Fed. Reg. 74284 (Dec. 13, 2012); CFTC Regulation 50.4.

22 CFTC Regulation 50.4(a).

23 CFTC Regulation 50.4(b).

(iii) Implementation Schedule for Cleared Swaps

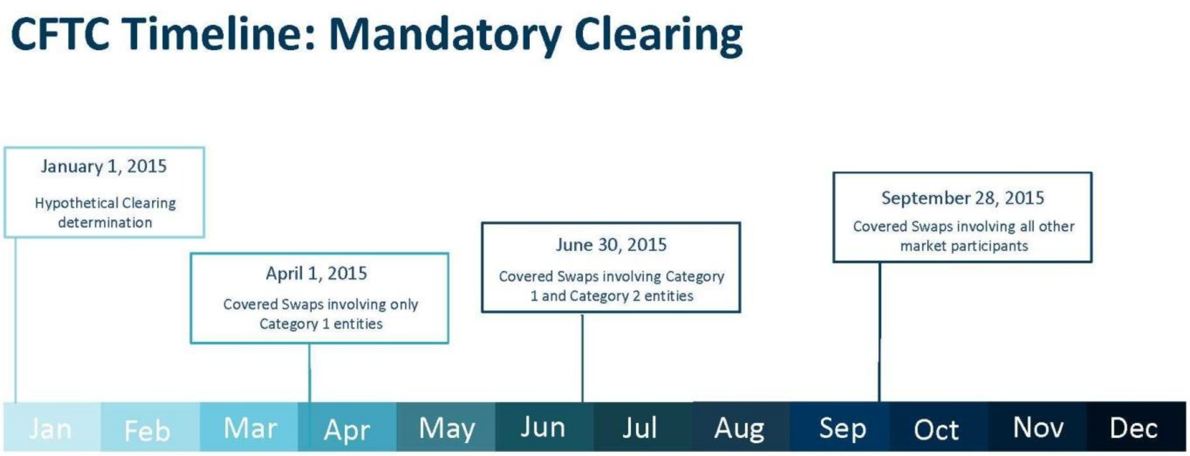
CFTC Regulation 50.25 divides market participants into three categories with staggered compliance dates for clearing mandates:

- *Category 1 Entities:* Registered SDs, registered MSPs, and active funds.[24] Swaps between Category 1 entities must comply within 90 days after a mandatory clearing designation.

- *Category 2 Entities:* Commodity pools, private funds other than active funds, and persons predominantly engaged in the business of banking or in activities that are financial in nature as defined in Section 4(k) of the U.S. Bank Holding Company Act of 1956 as amended, provided that in each case the entity is not a third party subaccount. Registered investment companies engaging in swap transactions are Category 2 entities. Swaps between a Category 1 entity and a Category 2 entity, or between two Category 2 entities, must comply within 180 days after a mandatory clearing designation.

- *All other entities:* Swaps between all other entities must comply within 270 days after a mandatory clearing designation.

The following chart sets forth the standard implementation schedule under CFTC Regulation 50.25 for future mandatory clearing of additional categories of swaps covered by a CFTC clearing determination (assuming hypothetically and for simplicity that the next mandatory clearing determination is made on January 1, 2015).



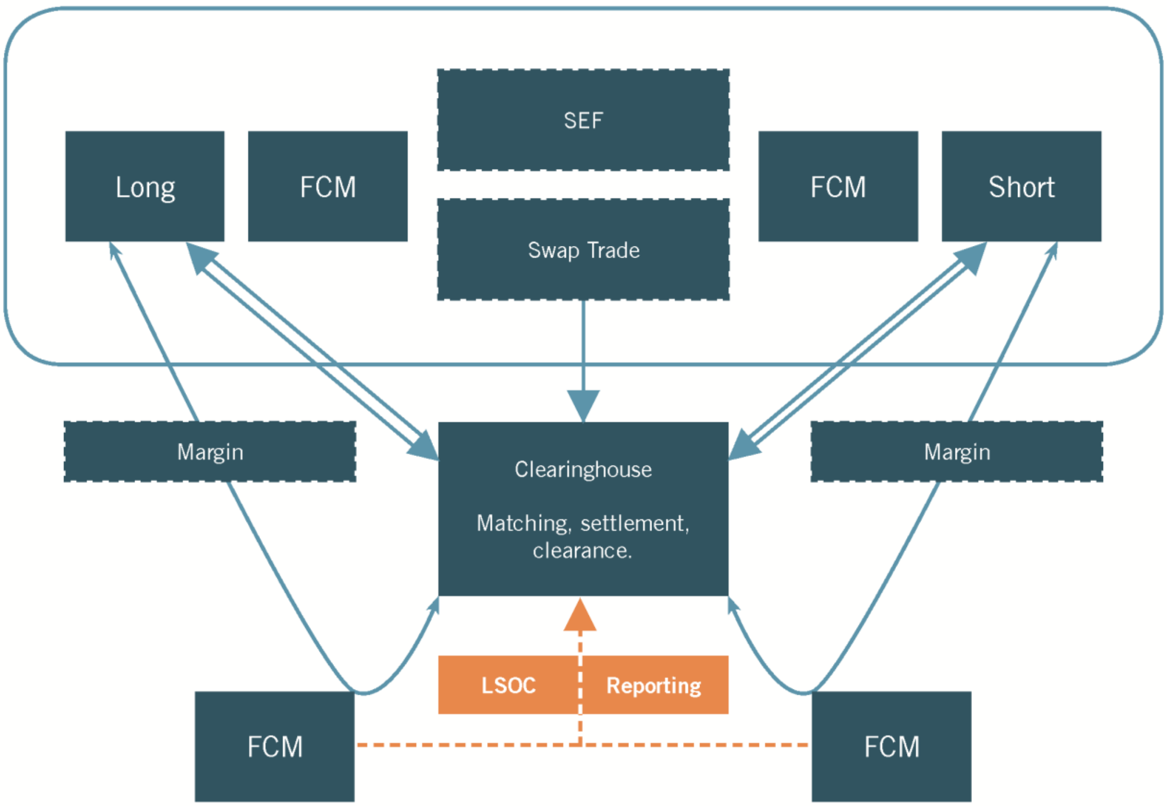
(iv) Clearing Process

Cleared swaps may be exchange traded or traded bilaterally OTC. FCMs facilitate clearing of both exchange-traded and bilateral OTC cleared swaps. An FCM is an individual or organization that (i) solicits or accepts orders to buy or sell futures contracts, options on futures contracts, commodity options, retail off-

[24] An "active fund" is any private fund as defined in Section 202(a)(29) of the U.S. Investment Advisers Act of 1940 as amended that is not a third party subaccount and that executes more than 200 swaps per month on average for the last 12 months prior to the clearing determination. *See Swap Transaction Compliance and Implementation Schedule: Clearing Requirement Under Section 2(h) of the CEA; Final Rule*, 77 Fed. Reg. 44441, 44444 (Jul. 30, 2012).

exchange forex contracts, or swaps, and (ii) accepts money or other assets from customers to support such orders.[25]

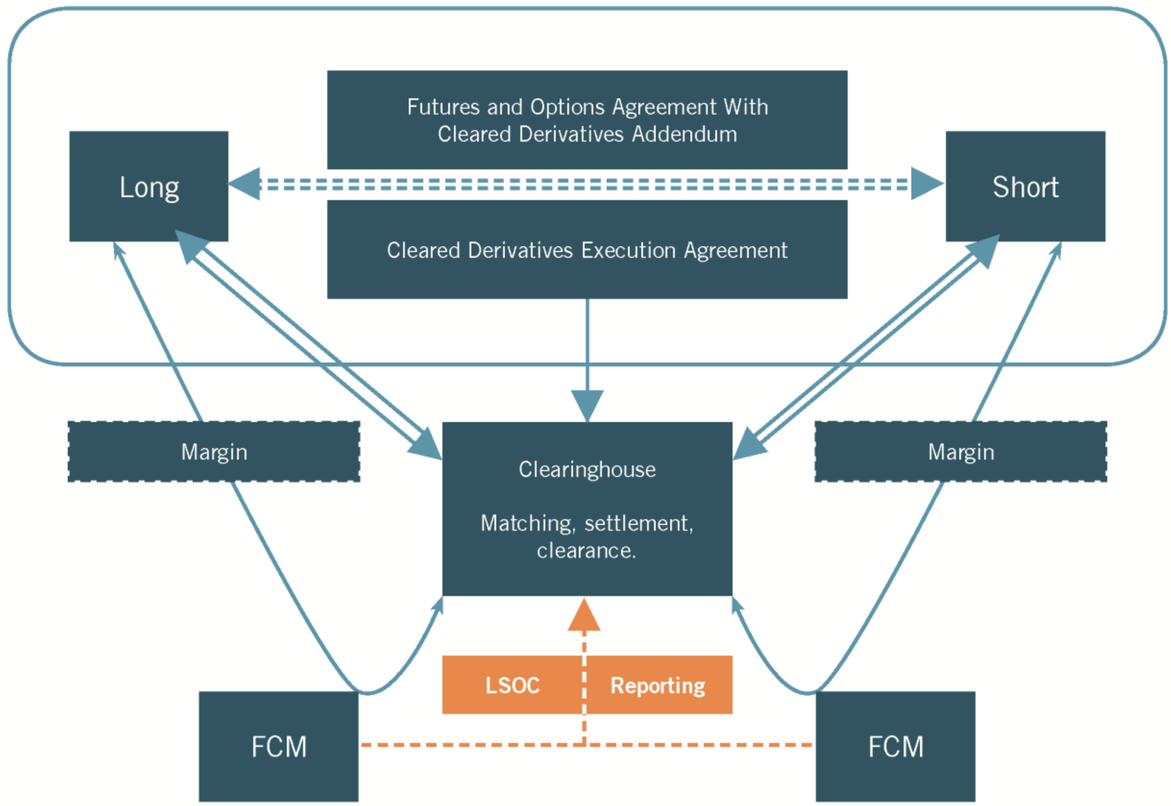
For an *on-exchange swap transaction*, a party executes a swap with another party on a DCM or SEF, either directly (as SEF member) or through an FCM. The relationship between the party and the FCM is governed by the terms of a Futures and Options Agreement along with a Cleared Derivatives Addendum published by the U.S. Futures Industry Association ("FIA") and the International Swaps and Derivatives Association ("ISDA") ("Cleared Derivatives Addendum"). The DCO (*i.e.*, clearinghouse) then steps between each party to the exchange-traded swap to be the universal counterparty. Each party faces the DCO through the party's respective clearing FCM, which posts margin and makes payments for all of its clients to the DCO on an aggregate basis (subject to certain customer protection rules, discussed herein). The following graphic depicts the process for clearing of exchange-traded swaps.



For an *OTC cleared swap transaction*, the buy-side participant (*e.g.*, a fund) and an SD or other permissible counterparty execute a swap directly and bilaterally. Following execution, the parties (or their executing brokers) "give up" the swap transaction under the terms of a Cleared Derivatives Execution Agreement for clearing through their respective clearing member FCMs. The relationship between the party and the FCM is governed by the terms of a Futures and Options Agreement with a Cleared Derivatives Addendum. After

25 CEA Section 1a(28).

the trade is submitted through an FCM to a DCO for clearing, each party faces the DCO as the universal counterparty through a clearing FCM, as in an on-exchange swap. The FCM posts margin and makes payments for all of its clients to the DCO on an aggregate basis. The following graphic depicts the process for clearing of OTC swaps.



For *both exchange-traded and OTC cleared swaps*, the DCO requires both "initial margin" (*i.e.*, a performance bond) and "variation margin" (*i.e.*, exposure margin based on market moves and volatility changes) from each respective clearing member FCM. Each FCM in turn may require initial and variation margin (generally in an amount in excess of that demanded by the clearinghouse, although this can be a highly negotiated point, as discussed herein) from its client.

(d) Trade Execution Requirements

(i) Swap Execution Facilities

Title VII added Section 2(h)(8) of the CEA, which mandates that a swap that is cleared on a DCO be traded on a board of trade designated as a DCM (*i.e.*, historically a commodity exchange, which now may list swaps for trading or processing) or SEF except where (i) no DCM or SEF makes a swap "available to trade", or (ii) the swap transaction is subject to the clearing exemption under Section 2(h)(7) of the CEA. The determination as to whether a cleared swap has been "made available to trade" is issued by the CFTC ("MAT determination").

Title VII also amended the CEA to require the designation, registration, and regulation of SEFs, which are defined in the CEA as trading systems or platforms "in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants" in the systems or platforms.[26]

On June 4, 2013, the CFTC adopted final rules regarding core principles and certain other requirements that apply to registered SEFs ("SEF Final Rules"), which became effective August 5, 2013.[27] The SEF Final Rules required SEFs to register with the CFTC and to comply with CFTC regulations beginning October 2, 2013 (although the compliance date for SEF core principles was delayed until November 1, 2013).[28] As a result, many trading systems and platforms that operated in an unregulated capacity pursuant to certain temporary relief from the CFTC[29] and CFTC no-action letters extending the SEF compliance dates[30] are now required to operate as registered and regulated SEFs.

(ii) Made Available to Trade Determinations

On June 4, 2013, the CFTC published Regulations 37.10 (SEFs) and 38.12 (DCMs) to establish a process through which registered SEFs and DCMs could submit their determinations to the CFTC for approval that a swap is available to trade for the purposes of the trade execution requirement.[31]

Under these rules, DCMs or SEFs must consider a series of factors in determining whether a swap is made available to trade, including:

- whether there are ready and willing buyers and sellers;
- the frequency or size of transactions on DCMs or SEFs, or of bilateral transactions;
- the trading volume on DCMs or SEFs, or of bilateral transactions;
- the number and type of market participants;

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26 CEA Sections 1a(50) and 5h. CEA Section 5h establishes a registration requirement for SEFs and sets forth certain "core principles" with which SEFs are required to comply. CEA Section 2(h)(8) requires that trades in a swap subject to a mandatory clearing requirement be executed on a DCM or a SEF.

27 *Core Principles and Other Requirements for Swap Execution Facilities*, 78 Fed. Reg. 33476 (Jun. 4, 2013). DCMs were already regulated prior to the adoption of Dodd-Frank and are subject to a different (but somewhat overlapping) set of core principles under CEA Section 5.

28 *Time-Limited No-Action Relief for Temporarily Registered Swap Execution Facilities from Enforcement Responsibilities Under Commission Regulations 37.200(a), 37.200(b), 37.201(b)(1), 37.201(b)(3), 37.201(b)(5), 37.202(b) and 37.203*, CFTC No-Action Letter No. 13-57 (Sept. 27, 2013).

29 *Effective Date for Swap Regulation*, 76 Fed. Reg. 42508 (Jul. 19, 2011)("SEF Order"); *Amendment to July 14, 2011 Order for Swap Regulation*, 76 Fed. Reg. 80233 (Dec. 23, 2011); *Second Amendment to July 14, 2011 Order for Swap Regulation*, 77 Fed. Reg. 41260 (Jul. 13, 2012).

30 *Preservation of the Regulatory Status Quo Established with Respect to Certain Transactions by the Commission's Second Amendment to July 14, 2011 Order for Swap Regulation*, CFTC No-Action Letter 12-48 (Dec. 11, 2012); *Extension of the Regulatory Status Quo Established with Respect to Certain Transactions by the Commission's Second Amendment to the July 14, 2011 Order for Swap Regulation*, CFTC No-Action Letter No. 13-28 (Jun. 17, 2013).

31 *Process for a Designated Contract Market or Swap Execution Facility to Make a Swap Available to Trade, Swap Transaction Compliance and Implementation Schedule, and Trade Execution Requirement Under the Commodity Exchange Act; Final Rule*, 78 Fed. Reg. 33606 (Jun. 4, 2013).

- the bid/ask spread; and
- the usual number of resting firm or indicative bids and offers.[32]

A DCM or SEF may only submit its application to initiate the CFTC's MAT determination process for a swap (i) that lists for trading on a voluntary basis, and (ii) that is subject to mandatory clearing.[33] Once the DCM or SEF makes its initial determination, the DCM or SEF must then submit its determination to the CFTC for (i) approval as described in CFTC Regulation 40.5, or (ii) self-certification as described in CFTC Regulation 40.6. Under CFTC Regulation 40.5, the submission is deemed approved by the CFTC 45 days after receipt by the CFTC unless the submission is inconsistent with the CEA or CFTC regulations. The CFTC may extend the review period for another 45 days. Under CFTC Regulation 40.6, the CFTC has 10 business days to review the submission before it is deemed certified. The CFTC may stay the certification for an additional 90 days, including a concurrent 30-day public comment period for market participants.

Once the CFTC approves a transaction as made available to trade or the transaction is deemed certified as available to trade, all other DCMs and SEFs that list or offer that swap for trading must do so in accordance with the trade execution requirements and such swap must be traded on a DCM or SEF under CEA Section 2(h)(8), subject to certain limited exceptions.

In addition, the CFTC may issue a determination that a swap is no longer available to trade upon determining that no DCM or SEF lists such swap for trading.

Under these rules, SEFs and DCMs could submit initial determinations beginning on August 5, 2013. As of March 9, 2014, the CFTC has deemed five self-certified MAT determinations as certified, making certain IRS and CDS subject to the mandatory trade execution requirement.

Although the CFTC stayed the certification for 90 days for all of the prior MAT determinations, the CFTC is not required to do so; and a new MAT determination could be deemed certified in only 10 business days. There is industry concern that this process is too expedited and does not allow sufficient time for industry commentary and sufficient opportunity for CFTC analysis, inquiry, and discretion in making MAT determinations. In particular, industry participants note there are no mandatory, objective standards or thresholds to be used by DCMs and SEFs. The authority to establish MAT determination standards has been effectively delegated to DCMs and SEFs, and the CFTC has little opportunity or basis to disagree with a MAT determination.

(iii) Exchange Trading of Package Transactions

Through a series of no-action letters, the CFTC staff has granted time-limited no-action relief to entities or counterparties engaging in "package transactions" from the requirement that swaps subject to the clearing requirement be executed on a DCM or SEF.[34] A package transaction is generally a transaction that involves

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32 CFTC Regulations 37.10(b) and 38.12(b).

33 CFTC Regulations 37.10(a)(2) and 38.12(a)(2). As noted herein, to date only certain CDS and IRS are subject to the mandatory clearing requirement pursuant to CFTC Regulation 50.4.

34 *Extension of No-Action Relief from the Commodity Exchange Act Sections 2(h)(8) and 5(d)(9) and from Commission Regulation § 37.9 and Additional No-Action Relief for Swap Execution Facilities from Commission Regulation § 37.3(a)(2) for Swaps Executed as Part of Certain Package Transactions*, CFTC No-Action Letter No. 14-137 (Nov. 10, 2014); *No-Action Relief from the Commodity Exchange Act Sections 2(h)(8) and 5(d)(9) and from Commission Regulation § 37.9 for Swaps Executed as Part of Certain Package Transactions and No-Action Relief for Swap Execution Facilities from Compliance with Certain Requirements of Commission Regulations § 37.9(a)(2), § 37.203(a) and § 38.152 for Package Transactions*, CFTC No-Action Letter No. 14-62 (May 1, 2014); *No-Action Relief from the Commodity Exchange Act*

either a combination of swaps or swaps and other financial instruments where only one of the swaps is subject to mandatory trade execution and clearing, that is treated by the parties as a single trade with multiple legs.[35] In addition, SEFs and DCMs facilitating trading for these transactions have been granted relief from certain prescribed execution methods, including those in CFTC Regulation 37.9 (requiring swaps that are subject to the trade execution requirement and are traded on a SEF be executed on a SEF by either an Order Book or a Request For Quote System that operates in conjunction with an Order Book), CEA Section 5(d)(9) (requiring swaps executed on a DCM to be executed pursuant to Subpart J of Part 38 of CFTC Regulations, which implements DCM Core Principle 9), and in some instances CFTC Regulation 37.3(a)(2) (requiring SEFs to offer an Order Book as a minimum trading functionality).

The date upon which the no-action relief expires varies depending on the type of package transaction involved. The no-action relief is intended to provide SEFs and DCMs with flexibility in choosing the methods of execution that they may offer for swap components of package transactions, and enables market participants to transition their trading of these swap components onto SEFs and DCMs. While the no-action relief is in effect, the CFTC intends to gather and review trading and volume data associated with the various categories of package transactions in order to determine whether SEFs and DCMs can offer the capability to transact swap components of package transactions through competitive means of execution.

(iv) SEF Membership, Rulebook, and User Agreement Issues

Under the CEA and CFTC regulations, a SEF is required to implement rules governing its operations, including rules relating to trading procedures for orders executed on the SEF.[36] One such rule requires that a SEF provide for the financial integrity of its transactions by only allowing entities qualifying as ECPs to become members of the SEF.[37] SEFs are also required to establish rules and criteria governing market participants who utilize a SEF's services that are designed to deter market abuses. In addition to adopting rules, one of the core principles set forth in CEA Section 5h requires a SEF to enforce compliance with its rules.[38]

In order to comply with these requirements, each SEF has adopted its own rulebook governing the activities of its participants and has adopted its own user agreement to be executed by market participants in order to permit participants to trade (or continue to trade) on its platform. By executing a user agreement, a market participant agrees to adhere to the SEF's rulebook and be subject to its jurisdiction. Compliance with these requirements began November 1, 2013.[39]

Sections 2(h)(8) and 5(d)(9) and from Commission Regulation § 37.9 for Swaps Executed as Part of a Package Transaction, CFTC No-Action Letter No. 14-12 (Feb. 10, 2014).

35 Specifically, a package transaction is one that involves two or more instruments and: (i) is executed between two counterparties; (ii) is priced or quoted as one economic transaction with near simultaneous execution of all components; (iii) has at least one component that is a swap that is made available to trade; and (iv) the execution of each component is contingent upon the execution of all other components.

36 CEA Section 5h(f)(2)(C); CFTC Regulations 37.200 and 37.201.

37 CFTC Regulation 37.702.

38 CFTC Regulation 37.201(b) provides that a SEF must establish and impartially enforce compliance with its rules, including but not limited to: (i) the terms and conditions of any swaps traded or processed on or through the SEF; (ii) access to the SEF; (iii) trade practice rules; (iv) audit trail requirements; (v) disciplinary rules; and (vi) mandatory trading requirements.

39 *Time-Limited No-Action Relief for Temporarily Registered Swap Execution Facilities from Enforcement Responsibilities Under Commission Regulations 37.200(a), 37.200(b), 37.201(b)(1), 37.201(b)(3), 37.201(b)(5), 37.202(b) and 37.203*, CFTC No-Action Letter No. 13-57 (Sept. 27, 2013).

The adviser of a fund executing transactions directly on a SEF (as opposed to executing through another member, such as an FCM) is required to be a direct member of that SEF and agrees to adhere to the SEF's rulebook and user agreement. Market participants will generally be required to have agreed to the rules of a SEF prior to utilizing that SEF to execute swap transactions.

(v) Other Requirements Applicable to SEF Members

In addition to the requirements imposed by SEF user agreements and rulebooks, additional CFTC regulations apply to SEF members, such as the recordkeeping rules in CFTC Regulations 1.31, 1.35, and 4.23 (as applicable).

(e) Swap Data Reporting Requirements

(i) SDR Reporting: Swap Initiation and Continuation Data

Dodd-Frank amended the CEA to impose new reporting requirements for swap transactions. CEA Section 2(a)(13)(G) requires reporting of all swap transactions to a new class of registered entities, swap data repositories ("SDRs"). CEA Section 21(b) directs the CFTC to determine what data elements must be reported as well as standards for the collection and maintenance of such data. CEA Section 4r specifically addresses uncleared swaps, assigning reporting responsibilities to various swap counterparties to ensure that at least one counterparty to each swap transaction reports the transaction to an SDR.

Under the CFTC's swap transaction data reporting rules that implement these CEA provisions, two main categories of data must be reported to an SDR: (i) swap creation data, which consists of the swap's primary economic terms ("PET") and confirmation data; and (ii) swap continuation data, which consists of valuation and life cycle event data.[40]

CEA Section 2(a)(13)(E) addresses the dissemination of this information to the public by directing the CFTC to prescribe rules for cleared swaps that ensure that the identities of swap participants are not disclosed to the public, and that appropriate delays are used in the reporting of large notional swap transactions, and to consider any impact of swap reporting on market liquidity. CEA Section 2(a)(13)(B) gives the CFTC general discretion to determine the form and timing of all public reporting of swap data.

The CFTC makes certain data publicly available through its Weekly Swaps Report ("Swaps Report"), which is available at http://www.cftc.gov/MarketReports/SwapsReports. The Swaps Report includes: (i) the gross notional outstanding value for IRS, CDS, equity swaps, other commodity swaps, and FX swaps; (ii) the weekly transactions measured by dollar volume for IRS and CDS; and (iii) the weekly transactions measured by ticket volume for IRS and CDS. The Swaps Report further provides detailed breakdowns of the swap markets by product type, currency, tenor, participant type, and cleared or uncleared swaps for each asset class. The November 12, 2014 Swaps Report shows that, as of October 31, 2014, the gross notional outstanding amount totals were approximately $342 trillion for IRS (65% of which were cleared) and $6.7 trillion for CDS (24% of which were cleared).

(ii) Duty to Report

Non-SD and non-MSP counterparties ("Non-SD/MSPs") will only bear reporting responsibilities if the other counterparty is a Non-SD/MSP, and only under one of three circumstances:

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[40] CFTC Regulations 45.1, 45.3, and 45.4.

- If the swap *is* executed on or pursuant to the rules of a SEF or DCM and the swap is *not* cleared by a DCO, then the Non-SD/MSP will have to provide continuation data for the life of the swap (but will not need to provide creation data, which is reported by the SEF or DCM).

- If the swap is *not* executed on or pursuant to the rules of a SEF or DCM and the swap *is* accepted for clearing by a DCO *after* the applicable deadline for reporting PET data has passed, then the Non-SD/MSP must report the PET data (but does not need to provide confirmation data or any continuation data, both of which are provided by the DCO).

- If the swap is *not* executed on or pursuant to the rules of a SEF or DCM and the swap is *not* cleared, then the Non-SD/MSP must assume all reporting obligations for both creation data and continuation data.[41]

(f) Proposed Margin Requirements for Uncleared Swaps

Dodd-Frank required the adoption by the CFTC and the SEC as well as the U.S. Federal Reserve Bank, the U.S. Office of the Comptroller of Currency, the U.S. Federal Deposit Insurance Corporation ("FDIC"), the U.S. Farm Credit Administration, and the U.S. Federal Housing Finance Authority (collectively "prudential regulators") of margin requirements for uncleared derivatives.[42] These requirements have not yet been adopted as final by any regulator. Currently, each of the (i) CFTC, (ii) SEC, and (iii) prudential regulators have outstanding rule proposals that would implement this mandate, if adopted. The Basel Committee on Banking Supervision and the International Organization of Securities Commissions ("BCBS/IOSCO") also released a policy framework in 2013 intended to establish minimum requirements to guide various regulators in establishing margin rules.

(i) BCBS/IOSCO Margin Policy Framework

In response to a directive from the Group of Twenty ("G20") in 2011 to develop margin requirements for non-cleared derivatives, BCBS/IOSCO released a final policy framework on September 2, 2013 that is intended to establish minimum requirements to guide regulators in G20 nations in the adoption of margin rules for uncleared derivatives.[43]

This framework applies beyond swaps and security-based swaps to cover all non-cleared derivatives transactions. Financial firms and systemically important nonfinancial firms with at least Euro 8 billion gross notional amount outstanding of uncleared derivatives (including FX forwards and FX swaps) would be required to collect and post initial and variation margin, with exceptions for transactions involving non-financial entities that are not "systemically important," sovereigns, central banks, multilateral development banks, and the Bank for International Settlements. Regulators in each country are charged with defining which entities are "systemically important."

The framework provides for a phase-in of margin requirements, beginning in December 2015. Initially, only variation margin must be exchanged, with the requirement to exchange initial margin phased in from 2015 to 2019, based on the size of the participant as measured by the notional amount of uncleared

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[41] CFTC Regulations 45.3, 45.4, and 45.8. *See also Swap Data Recordkeeping and Reporting Requirements; Final Rule*, 77 Fed. Reg. 2136, 2156-57 (Jan. 13, 2012) (codified at 17 C.F.R. pt. 45) (providing diagram illustrating allocation of reporting responsibilities).

[42] Dodd-Frank Section 764.

[43] Basel Committee on Banking Supervision & Board of the International Organization of Securities Commissions, *Margin Requirements for Non-Centrally-Cleared Derivatives* (Sept. 2, 2013), *available at* http://bis.org/publ/bcbs261.pdf.

derivatives (including FX forwards and FX swaps). The requirements only apply to new contracts entered into after the phase-in date of the applicable requirement.

The framework does not enumerate specific types of permissible collateral but rather requires national regulators to develop lists of acceptable collateral, which must be highly liquid and have the potential to withstand periods of financial uncertainty that may accompany the failure of a derivatives counterparty. The framework requires margin to be held in a manner that protects the posting party in the event that the collecting party enters bankruptcy, but permits rehypothecation under certain circumstances and subject to a series of protective limitations.

(ii) Prudential Regulators Margin Proposal

Dodd-Frank requires an SD, MSP, SBSD, or MSBSP ("Swap Entity") that, in lieu of being regulated by the CFTC or the SEC is regulated by a prudential regulator, to meet margin requirements set by such prudential regulator. If there is no prudential regulator, Dodd-Frank requires such Swap Entities to meet CFTC and SEC margin requirements (discussed below).

The prudential regulators initially proposed their margin rules on May 11, 2011.[44] On September 3, 2014, the prudential regulators re-proposed their margin rules.[45] The current proposal of the prudential regulators largely tracks the framework and standards published by BCBS/IOSCO. The proposal would only apply to uncleared swaps entered into after the effective dates of the regulation.

The prudential regulators' proposal divides counterparties into four categories: (i) Swap Entities; (ii) financial end-users with "material swaps exposure"; (iii) financial end-users without "material swaps exposure"; and (iv) non-financial end-users. A financial end-user would be considered to have material swaps exposure if its average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, FX forwards, and FX swaps with all counterparties for June, July, and August of the previous year exceeds $3 billion.

The proposed rules contemplate different requirements depending on the category of the counterparty, as follows:

- Swap Entities transacting with other Swaps Entities or financial end-users with material swaps exposure must collect and post initial and variation margin.

- Swap Entities transacting with financial end-users without material swaps exposure must collect and post variation margin.

- There are no specified minimum margin requirements for Swap Entities transacting with non-financial end-users.

A Swap Entity (and its affiliates) would be permitted to adopt a margin "threshold amount" of up to $65 million with respect to a counterparty (and its affiliates). This means that initial margin would only be required from a counterparty to the extent that the amount of required initial margin exceeds the $65 million threshold, and the Swap Entity (and its affiliates) would be unsecured for amounts below the threshold. Swap Entities would not be permitted to adopt a threshold amount for variation margin.

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[44] *Margin and Capital Requirements for Covered Swap Entities*, 76 Fed. Reg. 27564 (May 11, 2011).

[45] *Margin and Capital Requirements for Covered Swap Entities*, 79 Fed. Reg. 57348 (Sept. 24, 2014).

Initial margin would be calculated using a standardized margin schedule or an approved internal initial margin model. Eligible collateral for initial margin would include cash, debt securities that are issued or guaranteed by the U.S. Department of the Treasury ("Treasury Department") or by another U.S. Government agency, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, multilateral development banks, certain U.S. Government-sponsored enterprises, certain non-U.S. governments, and certain corporate issuers, certain listed equities, and gold, subject to prescribed haircuts.

Compliance with the initial margin requirements would be phased in between December 1, 2015 and December 1, 2019 based on each relevant party's notional amount of uncleared derivatives (including physically settled FX forwards and FX swaps).

Variation margin would be calculated as the change in value of the obligations under one or more swaps between the parties since the last such payment. Eligible collateral for variation margin would be cash only, denominated in U.S. dollars or in the currency in which payment obligations under the swap are required to be settled. Counterparties would be required to comply with the variation margin requirements beginning December 1, 2015.

All margin posted by a Swap Entity other than variation margin would be required to be held by an unaffiliated third-party custodian, and all required initial margin collected by a Swap Entity would be required to be held by an unaffiliated third-party custodian. In other words, third-party segregation protections apply to excess initial margin posted by a Swap Entity, but not to excess initial margin collected by a Swap Entity. Third-party custodians would not be permitted to rehypothecate margin. The applicability of the third-party segregation protections under the prudential regulators' proposal would differ from the applicability of the segregation requirement under the CFTC proposal discussed below.

(iii) CFTC Margin Proposal

The CFTC initially proposed its margin rules on April 28, 2011.[46] The CFTC re-proposed its margin rules on September 17, 2014,[47] just days after the publication of the prudential regulators' proposal. The CFTC's re-proposed rules would impose margin requirements on SDs and MSPs for which there is no prudential regulator ("Covered Swap Entities").

The CFTC's re-proposed rules are substantially similar to the prudential regulators' proposal.[48] One notable difference is that the CFTC proposal includes more detailed requirements with respect to control mechanisms for variation margin, including a requirement that a Covered Swap Entity calculate variation margin on a daily basis for itself and for each counterparty using inputs from recently executed transactions,

46 *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 23732 (Apr. 28, 2011).

47 *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 79 Fed. Reg. 59898 (Oct. 3, 2014).

48 Eligible collateral for initial margin under the CFTC's proposal is substantially similar to eligible collateral under the prudential regulators' proposal, and would include U.S. dollars, cash in a currency in which payment obligations under the swap are required to be settled, U.S. Treasury securities, certain securities guaranteed by the United States, certain securities issued or guaranteed by the European Central Bank, a sovereign entity, or the Bank for International Settlements, certain corporate debt securities, certain equity securities contained in major indices, major currencies, gold, and other publicly-traded debt that has been deemed acceptable as initial margin by a prudential regulator. Eligible collateral for variation margin under the CFTC proposal would be cash only, which is the same as eligible collateral for variation margin under the prudential regulators' proposal.

valuations by third parties, or other objective criteria. In addition, the CFTC's proposal does not require that any excess initial margin be held by a third-party custodian, regardless of whether it is posted or collected by a Covered Swap Entity.

As the margin rules are the last significant issues for the CFTC to consider under Dodd-Frank, it is expected that the rules will be finalized in the near future.

(iv) SEC Margin Proposal

The SEC proposed its margin rules on November 23, 2012, prior to the publication of the BCBS/IOSCO framework. As a result, it is likely that the SEC will re-propose its rules to align them with the BCBS/IOSCO framework.

The SEC's proposed rules would apply to SBSDs and MSBSPs.[49] The proposal would require:

- SBSDs to collect initial and variation margin from all OTC security-based swap counterparties (*i.e.*, unilateral coverage of current and potential future exposure) except for commercial end-users that are using the swaps for hedging; and

- MSBSPs to collect or post only variation margin (*i.e.*, bilateral coverage of current exposure) based on daily exposure calculations, except for exposure to commercial end-users and SBSDs.

The margin requirements would apply to any accounts that are holding uncleared security-based swaps and would be based on the total exposure to the account, including exposure due to instruments other than swaps. The requirements would only apply to security-based swaps entered after the effective date of the final rule.

The SEC proposal would limit permitted collateral to cash, securities, or money market instruments, as long as the securities or money market instruments had a ready market and could be offered and sold to the public. The SBSD or MSBSP would be required to allow the counterparty to elect to have the collateral held by a custodian. However, if the counterparty elects to have collateral held by a custodian, such collateral would no longer meet the proposal's collateral requirements—*i.e.,* that an SBSD or MSBSP must have physical possession or control over a counterparty's collateral and must be able to promptly liquidate collateral. Under the proposal, collateral not meeting those requirements cannot be included when the SBSD or MSBSP calculates the equity in a counterparty's account, which means that the SBSD or MSBSP would be required to take a capital charge in an amount equal to the amount of margin that the SBSD or MSBSP is required to collect from the counterparty.

(g) Trade Documentation

(i) Clearing Agreements and Related Documentation

FCMs generally document clearing relationships with their clients using a Futures and Options Agreement and a Cleared Derivatives Addendum. The Cleared Derivatives Addendum is a template for FCMs and their customers to document their relationship with respect to on-exchange and cleared OTC swaps and is usually customized in some fashion by each FCM. It includes representations for each party to make regarding certain clearing-related matters (such as the treatment of customer collateral), and also sets forth

[49] *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealer; Proposed Rule*, 77 Fed. Reg. 70214 (Nov. 23, 2012) (to be codified at 17 C.F.R. pt. 240). As noted herein, SBSDs and MSBPs are generally the counterparts to SDs and MSPs that trade SEC-regulated products.

the close-out methodology for cleared OTC swaps, the triggers for liquidation, and provisions for valuing the terminated trades (among other provisions). It also governs tax issues regarding cleared OTC transactions.

Fund groups generally negotiate the terms of the Cleared Derivatives Addendum to protect against FCM credit risk and add a number of substantive terms, including among other things:

- Limits on margin charged by the FCM to match the rates charged by the applicable clearinghouse.
- Required notice periods prior to imposition of additional margin cushion requirements by the FCM.
- Morning margin call deadlines for same-day margin delivery; a grace period of one day for delivery of margin; and requirements for daily return of excess margin in accordance with SEC staff no-action relief under Rule 17f-6 under the Investment Company Act.[50]
- Limits on the FCM's ability to (i) impose new position limits that are more restrictive than those of the CFTC and clearinghouse, or (ii) reduce FCM existing swap position limits without prior notice.
- Required notice period prior to FCM close-out of open positions absent an event of default.
- FCM commitment to clear new orders and accept transactions ported from another FCM if the orders or transactions are "conforming swap transactions" that fall within agreed-upon portfolio limitations.
- Hard deadline for porting swap transactions away from the FCM.[51]
- Limits on events of default with respect to the customer so that only "credit-bearing" events of default (*i.e.*, failure to pay margin and bankruptcy) can trigger termination of the relationship.
- Agreed-upon schedules for financing charges/credits and settlement fees.
- Requirement that the FCM pay interest on credit balances in the customer account.
- Right of set-off against amounts owed by the FCM upon its insolvency.[52]

(ii) ISDA Framework and Protocols

ISDA has published a number of protocols that serve to amend outstanding ISDA Master Agreements (and related documentation) to incorporate certain information required under Dodd-Frank and associated CFTC

50 *See, e.g.*, Chicago Mercantile Exchange (Cash-Settled Commodity Index Swaps and Foreign Currency Swap Contracts) (pub. avail. Jul. 10, 2013); Chicago Mercantile Exchange (Credit Default Swaps and Interest Rate Swaps) (pub. avail. Dec. 26, 2013); ICE Clear Credit LLC (pub. avail. Dec. 26, 2013); LCH.Clearnet Limited and LCH.Clearnet LLC (pub. avail. Dec. 26, 2013).

51 Although Rule 2-27(a) of the U.S. National Futures Association requires porting within three business days, there is the view that employees of an insolvent FCM may be more likely to provide porting in a timely manner if there is a contractual obligation to do so.

52 Although an FCM is an agent of its customers and cleared swap customer collateral is subject to certain customer protections (discussed herein), cleared swap customers still face the risk of FCM bankruptcy with concurrent shortfalls in segregated customer funds due to operational risks (*e.g.*, negligence, theft, or other mishap).

rulemakings ("ISDA Dodd-Frank Protocols"). The ISDA Dodd-Frank Protocols are contractual agreements between counterparties and do not impose any regulatory obligations on an adherent. Certain regulatory requirements may apply regardless of whether a participant has adhered to any ISDA Dodd-Frank Protocols, depending on the participant's trading activities. The ISDA Dodd-Frank Protocols attempt to streamline the regulatory compliance process for swaps market participants.

There are currently multiple ISDA Dodd-Frank Protocols, the two most relevant ones being the ISDA August 2012 Dodd-Frank Protocol ("Protocol 1.0") and the ISDA March 2013 Dodd-Frank Protocol ("Protocol 2.0"). The key distinction is that Protocol 1.0 is designed to help adherents comply with the CFTC's Business Conduct Rules (also known as the Category B Transaction-Level Requirements),[53] while Protocol 2.0 is aimed to facilitate compliance with certain Category A Transaction-Level Requirements, described in greater detail herein.[54] Counterparties may adhere to either or both protocols. ISDA has also published certain other forms relating to Dodd-Frank, including a form account control agreement and a cross-border swaps representation letter.

A. Protocol 1.0

To help ensure an SD's compliance with the Business Conduct Rules, Protocol 1.0 facilitates the delivery of extensive "know your customer" information from the counterparty to the SD.[55] Additional disclosure is required for Special Entities as defined in the CFTC regulations.[56]

Protocol 1.0 also requires the counterparty to make a number of representations and covenants. Among these are the following obligations:

- To promptly notify the SD of any material change in information.[57]
- To promptly provide the SD with "any information reasonably requested" to enable the SD to comply with Dodd-Frank and related CFTC regulations.[58]
- To report certain "life cycle events" on the second business day following the day on which they occur.[59]
- To have adequate policies and procedures in place to ensure that the person (whether the adherent itself or a third-party service provider) evaluating swap recommendations and making trading decisions on behalf of the adherent is capable of doing so.[60]

B. Protocol 2.0

Protocol 2.0 facilitates compliance with the following Category A Transaction-Level Requirements:

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53 CEA Section 4s(h); CFTC Regulations Part 23, Subpart H.

54 CEA Sections 2(h),4s(i) and CFTC Regulations Part 23, Subpart I and Part 50.

55 ISDA August 2012 DF Supplement Schedule 2.

56 CEA Section 4s(h)(2)(C); CFTC Regulation 23.401(c).

57 ISDA August 2012 DF Supplement Section 2.3.

58 ISDA August 2012 DF Supplement Section 2.4.

59 ISDA August 2012 DF Supplement Section 2.10.

60 ISDA August 2012 DF Supplement Sections 3.1(a), 3.2(a), 4.1(c), 4.3(a), and 5.1(b)(1).

- *Portfolio Reconciliation*: Provides a framework for meeting the portfolio reconciliation and dispute resolution requirements in Dodd-Frank.[61] There are two reconciliation methods. Counterparties can choose either "Review" of Portfolio Data or "Exchange" of Portfolio Data. Portfolio reconciliation under Dodd-Frank is required either annually or quarterly, based on whether the counterparty surpasses a threshold of 100 trades per quarter.[62]

- *Swap Trading Relationship Documentation*: SDs must have documentation in place documenting the terms that govern the trading relationship with counterparties.[63]

- *Valuation and Dispute Resolution*: Protocol 2.0 specifically covers valuation and dispute resolution, while other terms will typically be found in swap confirmations.[64]

- *End-User Exception*: Dodd-Frank provided an exception from mandatory clearing if a customer qualifies as an "end-user."[65] Protocol 2.0 contains a number of representations for SDs to obtain the information needed to ensure regulatory compliance in lieu of clearing with these counterparties.[66] This generally does not apply to funds.

C. 2013 Account Control Agreement

On October 11, 2013, ISDA published the ISDA 2013 Account Control Agreement ("ISDA ACA"), which is designed to create a standardized tri-party control agreement to provide for segregation of collateral with a third-party custodian.[67] Similar to the ISDA Master Agreement and Credit Support Annex, the ISDA ACA consists of a standard agreement with an accompanying annex that allows parties to negotiate specific provisions and make certain elections.

D. Cross-Border Swaps Representation Letter

On August 19, 2013, ISDA published its "Cross-Border Swaps Representation Letter."[68] This letter is designed to allow swap counterparties to make representations to their SDs to assist SDs with determining whether the CFTC will assert jurisdiction over the swap pursuant to the CFTC's guidance and related "U.S. person" definition, published on July 26, 2013 (discussed herein). The letter requires the counterparty to represent whether it reasonably believes that it is a U.S. person. If the counterparty represents that it is not a U.S. person, it must further represent whether it is an "affiliate conduit" (as defined by the CFTC) or has a guarantee from a U.S. person, which may also subject the swap to CFTC jurisdiction.

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61 ISDA March 2013 DF Supplement Schedule 4.

62 CFTC Regulation 23.502(b)(3).

63 ISDA March 2013 DF Supplement Section 2.4.

64 ISDA March 2013 DF Supplement Schedule 3.

65 CFTC Regulation 50.50.

66 ISDA March 2013 DF Supplement Sections 2.9-2.11.

67 The ISDA ACA can be downloaded from the ISDA website at http://www2.isda.org/functional-areas/infrastructure-management/collateral/.

68 The Cross-Border Swaps Representation Letter can be downloaded from the ISDA website at http://www2.isda.org/dodd-frank-documentation-initiative/.

(iii) ISDA Temporary Suspension of Early Termination Rights After Counterparty Insolvency

International regulators have recently focused on early termination rights under derivatives contracts. Early termination rights, such as those contained in the ISDA Master Agreement, generally allow a party to a derivatives contract to terminate the contract if its counterparty files for bankruptcy or if certain other insolvency, receivership, or similar credit-related events occur with respect to either the direct counterparty or its related guarantor or "Specified Entities" (as defined by ISDA). Special resolution regimes (such as the Orderly Liquidation Authority or "OLA" under Title II of Dodd-Frank) impose a stay on early termination rights during the resolution of "systemically important financial institutions" ("SIFIs"). Thus, if a fund is transacting with a U.S. SIFI (directly or such SIFI is a guarantor or Specified Entity of the counterparty) that is undergoing resolution under the OLA, a stay would be imposed on the fund's early termination rights.

The U.S. Financial Stability Board ("FSB") has been concerned about the cross-border enforcement of stays imposed by special resolution regimes. Specifically, the FSB identified uncertainty with respect to the cross-border enforcement of stays of early termination rights as one of the main obstacles to the effective resolution of SIFIs that operate internationally. Most jurisdictions have not yet adopted statutes to recognize, enforce, or give legal effect to non-U.S. resolution measures. As a result, the FSB has been working to implement a contractual solution.[69] The FSB asked ISDA to develop a protocol through which counterparties would agree to be bound by special resolution actions taken by a non-U.S. resolution authority.

On November 12, 2014, ISDA announced that a new protocol to the ISDA Master Agreement was open for adherence. The new protocol – ISDA Resolution Stay Protocol ("Stay Protocol") – includes two parts. Part One deals with special resolution regimes and requires the parties adhering to the Stay Protocol to be subject to certain resolution regimes, such as a proceeding under the OLA or the European Union Bank Recovery and Resolution Directive ("BRRD").[70] Part Two of the Stay Protocol imposes a suspension or stay of termination rights (cross-default rights, but not direct default rights) when a U.S. financial holding company becomes subject to a proceeding under the U.S. Bankruptcy Code ("Bankruptcy Code").

Currently, 18 major global banks ("G-18 banks") have agreed to the new arrangement voluntarily, which means that transactions between the G-18 banks would be subject to the Stay Protocol. In 2015, FSB members will be proposing regulations in their respective jurisdictions to require prudentially regulated entities to adopt the Stay Protocol. If non-prudentially regulated firms (such as funds) want to continue trading with these prudentially regulated counterparties, they will be required as a practical matter to adhere to the Stay Protocol.

IV. REGULATION OF NON-U.S. SWAP ACTIVITIES

(a) CFTC and SEC Approaches

Title VII added Section 2(i) of the CEA, which provides that the CEA swap provisions generally do not apply to swap activities outside of the United States unless such activities (i) have a direct and significant

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[69] In late September 2014, the FSB also issued a consultation document on the cross-border recognition of resolution actions discussing both the statutory recognition frameworks and the contractual approaches to cross-border recognition of special resolution regimes.

[70] For example, under the Stay Protocol, a U.S. fund transacting with a U.S. subsidiary of a U.K. SIFI would agree to be subject to the BRRD if the U.K. SIFI becomes subject to a BRRD proceeding. Accordingly, the U.S. fund would be subject to any BRRD stay imposed as part of the U.K. SIFI resolution.

connection with activities in, or effect on, commerce of the United States, or (ii) contravene CFTC rules preventing the evasion of the CEA swap provisions. Similarly, Title VII added Section 30(c) to the Exchange Act, which provides that no Exchange Act security-based swap provisions will apply to a person conducting security-based swaps transactions outside of the jurisdiction of the United States unless such person transacts such business in contravention of SEC rules preventing the evasion of the SEC security-based swap provisions.

In July 2013, the CFTC approved and issued its final interpretive guidance and policy statement on the cross-border application of the swap regulation provisions of the CEA and related CFTC regulations ("CFTC Cross-Border Guidance").[71] One year later, the SEC adopted its rules on certain aspects of cross-border security-based swap activities, the SEC Cross-Border Rules described below.

Among other things, the CFTC Cross-Border Guidance provides the CFTC's definition of the term "U.S. person" with respect to the application of the CEA swap provisions and the CFTC swap regulations promulgated under Dodd-Frank. The SEC Cross-Border Rules provide the SEC definition of the term "U.S. person" with respect to cross-border security-based swap transactions, which definition differs from the CFTC definition.

In addition to setting the applicable U.S. person definitions, both the CFTC Cross-Border Guidance and the SEC Cross-Border Rules establish a procedure for the CFTC and SEC to allow certain entities that would otherwise be required to comply with CFTC or SEC regulations to comply with part or all of the regulatory regimes in which they are established rather than those of the CFTC or SEC, as applicable ("Substituted Compliance"). The CFTC Cross-Border Guidance also sets forth a framework for the application of the CFTC's substantive Entity- and Transaction-Level Requirements. In contrast, because the SEC had not yet adopted its substantive rules relating to security-based swaps when it adopted the SEC Cross-Border Rules, the SEC stated that its requirements relating to mandatory clearing, trade execution, regulatory reporting, and public dissemination (which will also apply to U.S. persons) will be addressed in future SEC rulemakings.

(b) CFTC and SEC U.S. Person Definitions

The CFTC and SEC U.S. person definitions are, or will be, used by SDs, SBSDs, MSPs, and MSBSPs in determining the U.S. requirements applicable to transactions and relationships with their counterparties.[72] Non-U.S. investment managers need to carefully consider the U.S. person status of natural person, entity, and collective investment vehicle clients under the CFTC Cross-Border Guidance and the SEC Cross-Border Rules in order to assess whether they need, or will need, to comply with the substantive regulation of swaps and security-based swaps in transacting in these products on their clients' behalf.

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71 *Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations; Rule*, 78 Fed. Reg. 45292 (Jul. 26, 2013). The CFTC also adopted an exemptive order providing temporary conditional relief from compliance with certain provisions of the CFTC Cross-Border Guidance for certain entities subject to the CFTC's definition of U.S. person ("Exemptive Order"). *Exemptive Order Regarding Compliance with Certain Swap Regulations*, 78 Fed. Reg. 43785 (Jul. 22, 2013). The relief provided in the Exemptive Order expired December 21, 2013, just before the CFTC issued its comparability determinations for Substituted Compliance, discussed in Section IV(c)(iii) herein.

72 The CFTC does not intend for the CFTC Cross-Border Guidance to address how a person's or entity's U.S. person status should be interpreted in connection with any other CEA provisions or CFTC regulations, including CFTC jurisdiction over commodity pool operators ("CPOs") and commodity trading advisors ("CTAs").

(i) CFTC U.S. Person Definition and Guidance

CFTC's U.S. Person Definition. The CFTC's U.S. person definition generally encompasses (i) persons located in the United States, and (ii) persons domiciled or operated outside of the United States but whose swaps activities satisfy the CEA jurisdictional nexus. The CFTC's U.S. person definition specifically includes:

(i) any natural person who is a resident of the United States;

(ii) any estate of a decedent who was a resident of the United States at the time of death;

(iii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund, or any form of enterprise similar to any of the foregoing (other than an entity described in prong (iv) or (v) below) ("legal entity"), in each case that is organized or incorporated under the laws of a state or other jurisdiction in the United States or having its principal place of business in the United States;

(iv) any pension plan for the employees, officers, or principals of a legal entity described in prong (iii) above, unless the pension plan is primarily for foreign employees of such entity;

(v) any trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust;

(vi) any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not a legal entity described in prong (iii) above and that is majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v) above, except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. persons;

(vii) any legal entity (other than a limited liability company, limited liability partnership, or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v) above and in which such persons bear unlimited responsibility for the obligations and liabilities of the legal entity; and

(viii) any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in prong (i), (ii), (iii), (iv), (v), (vi), or (vii) above.

The CFTC stated that the definition of U.S. person generally includes the foregoing persons but is "not limited to" such persons. The CFTC noted that there may be situations in which a person not specified within the enumerated definitions is appropriately treated as a U.S. person "in view of the relevant facts and circumstances and a balancing of the various regulatory interests that may apply."

Application to Separate Accounts. As noted above, under the CFTC's U.S. person definition, any legal entity organized or incorporated under the laws of a state or other jurisdiction in the United States *or having its principal place of business* in the United States is a U.S. person. The CFTC stated that, whether a legal entity (other than a collective investment vehicle) has its "principal place of business" in the United States, is a question of whether the entity has its "center of direction, control, and coordination of [its] business activities in the United States." The CFTC also quoted a U.S. Supreme Court decision regarding whether an entity has its principal place of business in the United States, stating "in practice, it should normally be the place where the [entity] maintains its headquarters—provided that the headquarters is the actual center of direction, control, and coordination, *i.e.*, the 'nerve center,' and is not simply an office where the corporation holds its board meetings."[73]

Application to Collective Investment Vehicles. The CFTC also stated that the primary focus for identifying the "principal place of business" of collective investment vehicles for determining the U.S. person status of such vehicles will be the location of the investment managers, fund sponsors and promoters, and sales and trading desks used by an investment manager, or the "actual center of direction, control and coordination" (*i.e.*, the "nerve center") of the collective investment vehicle.

In determining whether a vehicle's principal place of business is in the United States, the CFTC will focus primarily on where senior personnel are located. The CFTC will generally consider a vehicle's principal place of business to be in the United States if its senior principal personnel responsible for either (i) the "formation and promotion" of the vehicle or (ii) the "implementation of the vehicle's investment strategy" are in the United States, depending on the facts and circumstances. Additionally, the locations of the vehicle's board meetings, registered office, or books and records are generally not relevant to the vehicle's U.S. person status.

Also in conducting this inquiry, the CFTC will not look to the location of a vehicle's board of directors or trustees, because boards (while having the legal authority to manage the overall business of the vehicle and specifically to hire and fire the investment managers) do not have the function of actually implementing the investment objectives of funds and so would not be viewed as "key personnel."

The CFTC specifically stated that it would not consider a collective investment vehicle to be a U.S. person where some investment personnel or an independent, hired sub-adviser's personnel are located in the United States, so long as such persons report to non-U.S. persons who are considered to be fulfilling the "key functions relating to [the vehicle's] formation or the achievement of its investment objectives." This put to rest the concern that a non-U.S. vehicle would be considered a U.S. person solely because it employs a U.S.CTA that functions under the direction of senior personnel located outside of the United States.

The CFTC Cross-Border Guidance also provides that a legal entity, collective investment vehicle, or other relevant person will not be a U.S. person if it is publicly offered solely to non-U.S. persons and is not offered to U.S. persons.[74] However, even if a collective investment vehicle is not a U.S. person under prong (iii) of the CFTC's U.S. person definition, it may still be a U.S. person under prong (vi) if is it majority-owned by U.S. persons.

(ii) SEC U.S. Person Definition and Guidance

SEC's U.S. Person Definition. Under the SEC Cross-Border Rules, cross-border security-based swap activity includes security-based swap transactions between (i) a U.S. person and a non-U.S. person, (ii) two U.S. persons (where one party historically would have been viewed as outside the scope of SEC regulation), or (iii) two non-U.S. persons conducting a transaction "that otherwise occurs in relevant part within the United States."[75] Under the SEC Cross-Border Rules, the SEC's U.S. person definition includes:

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[73] CFTC Cross-Border Guidance, at 45309 (quoting Hertz Corp. v. Friend, 559 U.S. 77, 92-93 (2010)).

[74] CFTC Cross-Border Guidance, at 45314.

[75] SEC Cross Border Rules, at 39069 n.2. As an example, the SEC stated that a transaction where the performance of one non-U.S. counterparty is guaranteed by a U.S. person would constitute cross-border activity under the SEC Cross-Border Rules. SEC Cross-Border Rules, at 39069 n.2. The SEC expressly excluded from consideration in the SEC Cross-Border Rules "activities involving a transaction between two

(i) any natural person residing in the United States;

(ii) any partnership, corporation, trust, investment vehicle, or other legal person organized, incorporated, or established under the laws of the United States or having its principal place of business in the United States;

(iii) any account (whether discretionary or non-discretionary) of a U.S. person; and

(iv) any estate of a decedent who was residing in the United States at the time of death.

Application to Entities and Collective Investment Vehicles. As noted above, the SEC's U.S. person definition provides that any partnership, corporation, trust, investment vehicle, or other legal person organized, incorporated, or established under the laws of the United States or having its *principal place of business* in the United States is considered a U.S. person. The definition further provides that an entity's "principal place of business" is defined as "the location from which the officers, partners, or managers of the legal person direct, control, and coordinate the activities of the legal person."

Similar to the principles under the CFTC Cross-Border Guidance, the SEC Cross-Border Rules state that the principal place of business of an externally managed collective investment vehicle "is the office from which the manager of the vehicle primarily directs, controls, and coordinates the investment activities of the vehicle." For example, an investment fund organized in the Cayman Islands but managed by a portfolio manager conducting such management in the United States would be treated as a U.S. person. The SEC's definition specifically considers the location of "the office from which the manager" operates, and the SEC states that the location of the personnel directing the security-based swap activity for the vehicle will not by itself determine the vehicle's U.S. person status, as the focus of the definition is on "the location of a significant portion of the entity's financial and legal relationships."[76]

In contrast to the CFTC's U.S. person definition, the SEC's U.S. person definition does not look to the beneficial ownership of an investment fund. The SEC explained that it does not believe the risks associated with ownership interests in "passive investment vehicles" or in "majority-owned operating companies" are the risks that Title VII was meant to address.

(iii) Differences in the CFTC and SEC U.S. Person Definitions and Guidance

The CFTC's definition differs from the SEC's definition in a number of ways. First, the SEC's definition does not contain a carve-out for pension plans, which means that a pension plan for a non-U.S. company that is advised by a U.S. asset manager could be deemed to have its principal place of business in the United States and thus be a U.S. person for SEC purposes.

As noted above, beneficial ownership of an entity, a collective investment vehicle, or other relevant person by U.S. persons is not a factor under the SEC's definition. As a result, funds that are organized outside of the United States and operated by non-U.S. person managers could be treated as U.S persons under the CFTC's definition (by reason of being majority owned by U.S. persons) but treated as non-U.S. persons under the SEC's definition. In addition as noted above, an entity, a fund, or other relevant person that is publicly-offered only to non-U.S. persons but managed by a U.S. asset manager would be a non-U.S.

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non-U.S. persons where one or both are conducting dealing activity within the United States," and stated that it will address this issue in a subsequent release. The SEC Cross-Border Rules also set forth guidelines governing which cross-border transactions are counted toward meeting the thresholds for SBSD or MSBSP status, which designations subject the entity to SEC regulation.

[76] SEC Cross-Border Rules, at 39100.

person under the CFTC's definition but could be a U.S. person under the SEC's definition. Because the CFTC and the SEC adopted different U.S. person definitions, counterparties must assess their U.S. person status under both definitions in order to comply with applicable CFTC and SEC substantive regulations.

(c) Cross-Border Application of CFTC Swaps Requirements

Under the CFTC Cross-Border Guidance, (i) U.S. person CFTC-registered SDs and MSPs, (ii) non-U.S. person CFTC-registered SDs and MSPs, and (iii) certain other non-U.S. persons are each subject to the CFTC's Entity-Level requirements. A collective investment vehicle that is deemed to be a U.S. person will be subject to Transaction-Level Requirements.

(i) Entity-Level Requirements

The chart below summarizes the application of the CFTC's Entity-Level Requirements, including both the First[+] and Second[×] Categories of Requirements, based on the U.S. person status of a CFTC-registered SD or MSP:

U.S. SD or MSP (including an affiliate of a non-U.S. person); also applies when acting through a foreign branch	Apply
Non-U.S. SD or MSP (including an affiliate of a U.S. person)	First Category: Substituted Compliance Second Category: Apply for U.S. counterparties; Substituted Compliance* for SDR reporting with non-U.S. counterparties that are not guaranteed or conduit affiliates of U.S. persons

* Substituted Compliance applies upon "comparability determination" of CFTC, discussed below.

+ First Category is capital adequacy, chief compliance officer, risk management, and swap data recordkeeping (except CFTC Regulations 23.201(b)(3) and (4)).

× Second Category is SDR reporting, certain aspects of swap data recordkeeping relating to complaints and marketing and sales materials (CFTC Regulations 23.201(b)(3) and (4)), and large trader reporting.

In addition, where a U.S. person fund transacts in a swap with a non-U.S. person non-registrant, the CFTC large trader reporting, real-time public reporting, SDR reporting, and swap data recordkeeping requirements apply. In this case, obligations that would generally fall to the SD (*i.e.*, SDR reporting and swap data recordkeeping) could instead become the responsibility of the U.S. person vehicle.

Where neither the fund nor the non-registrant is a U.S. person, only large trader reporting will apply. A non-U.S. person fund could therefore limit its swap trading activity to transactions with non-U.S. person non-registrants and avoid needing to comply with most CFTC Entity-Level Regulations.

(ii) Transaction-Level Requirements

The chart below summarizes the application of the CFTC's Transaction-Level Requirements, including Category A[†] and Category B[‡] Requirements, based on the U.S. person status of the two counterparties to the swap:

		Buy Side			
		U.S. person	**Foreign Branch of U.S. Bank that is an SD or MSP**	**Non-U.S. person Guaranteed by, or Affiliate Conduit of, a U.S. person**	**Non-U.S. person NOT Guaranteed by, and NOT an Affiliate Conduit of, a U.S. person**
Sell Side	**U.S. person SD or MSP**	A and B: Apply	A and B: Apply	A and B: Apply	A and B: Apply
	U.S. person SD or MSP (when it solicits and negotiates through a foreign subsidiary or affiliate)	A and B: Apply	A: Apply B: Do not Apply	A: Apply B: Do not Apply	A: Apply B: Do not Apply
	Foreign Branch of U.S. Bank that is an SD or MSP	A and B: Apply	A: Substituted Compliance* B: Do not Apply	A: Substituted Compliance* B: Do not Apply	A: Substituted Compliance* B: Do not Apply
	Non-U.S. person SD or MSP (including an affiliate of a U.S. person)	A and B: Apply	A: Substituted Compliance* B: Do not Apply	A: Substituted Compliance* B: Do not Apply	A and B: Do Not Apply

* Substituted Compliance applies upon "comparability determination" of CFTC, discussed below.

† Category A is: clearing and swap processing; margining and segregation for uncleared swaps; trade execution; swap trading relationship documentation; portfolio reconciliation and compression; real-time public reporting; trade confirmation; and daily trading records.

‡ Category B consists of the Business Conduct Rules.

As set forth above, where a non-U.S. person fund transacts in swaps with a U.S. person SD, the fund will be subject to the CFTC's Transaction-Level Requirements with regard to its swaps. However, the actual compliance obligations will fall to the U.S. person SD.

A sub-set of the Transaction-Level Requirements would apply to transactions between a U.S. person fund and a non-U.S. person non-registrant, including clearing, trade execution, and real-time public reporting.

(iii) CFTC Substituted Compliance Regime

The CFTC Cross-Border Guidance provides that non-U.S. persons transacting with non-U.S. "branches" of U.S. SDs may comply with the regulatory regimes of the non-U.S. jurisdiction in which they operate instead of the CFTC regulations (subject still to CFTC examination and enforcement authority). This

Substituted Compliance regime is subject to a condition that the CFTC make a determination that the foreign jurisdiction's requirements "are comparable with and as comprehensive as the corollary area(s) [under the CFTC's] Entity- and Transaction-Level Requirements." Non-U.S. registered SDs and MSPs transacting with U.S. persons may only use Substituted Compliance for certain Entity-Level Requirements[77] and must still comply with all Transaction-Level Requirements.

Currently, the CFTC has approved comparability determinations relating to certain Transaction Level and Entity Level Requirements for the following six jurisdictions – Australia, Canada, European Union, Hong Kong, Japan, and Switzerland.

(iv) EMIR No-Action Relief

On July 11, 2013, the CFTC issued no-action relief to SDs and MSPs organized in the United States or the European Union from certain documentation, portfolio reconciliation, and other regulatory requirements under Dodd-Frank when subject to existing EU risk mitigation regulations that are "essentially identical" to CFTC regulations.[78]

This no-action relief applies solely to (i) uncleared swaps, and (ii) physically-settled FX forwards and FX swaps exempted from the definition of swap by the Treasury Department.[79]

(v) Transactions with Non-U.S. Desks of Non-U.S. Person SDs

The CFTC Cross-Border Guidance provides that Transaction-Level Requirements do not apply to transactions between a non-U.S. person SD/MSP and another non-U.S. person. However, the staff of the CFTC's Division of Swap Dealer and Intermediary Oversight ("DSIO") issued an advisory in November 2014 providing that a non-U.S. person SD (whether an affiliate or not of a U.S. person) regularly using personnel or agents located in the United States to arrange, negotiate, or execute a swap with a non-U.S. person generally would be required to comply with the Transaction-Level Requirements.[80] The initial compliance date with the advisory will be September 30, 2015 (unless modified via further guidance).

It is standard practice for many non-U.S. person sell-side entities to conduct certain swap trading activities through a U.S. person affiliate's trading desk. As a result, the application of the advisory may impact many non-U.S. person collective investment vehicles that have specifically structured their swaps trading relationships to be with non-U.S. non-registrants.

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77 These Entity-Level Requirements are the First Category, which include capital adequacy, chief compliance officer, risk management, and swap data recordkeeping (except CFTC Regulations 23.201(b)(3) and (4)).

78 *No-Action Relief for Registered Swap Dealers and Major Swap Participants from Certain Requirements under Subpart I of Part 23 of Commission Regulations in Connection with Uncleared Swaps Subject to Risk Mitigation Techniques under EMIR*, CFTC No-Action Letter No. 13-45 (Jul. 11, 2013).

79 *No-Action Relief for Registered Swap Dealers and Major Swap Participants from Certain Requirements under Subpart I of Part 23 of Commission Regulations in Connection with Uncleared Swaps Subject to Risk Mitigation Techniques under EMIR*, CFTC No-Action Letter No. 13-45, at 3 (Jul. 11, 2013).

80 *See Extension of No-Action Relief: Transaction-Level Requirements for Non-U.S. Swap Dealers*, CFTC No-Action Letter No. 14-140 (Nov. 14, 2014); *Extension of No-Action Relief: Transaction-Level Requirements for Non-U.S. Swap Dealers*, CFTC No-Action Letter No. 14-74 (June 4, 2014); *Extension of No-Action Relief: Transaction-Level Requirements for Non-U.S. Swap Dealers*, CFTC No-Action Letter No. 14-01 (Jan. 3, 2014); *No-Action Relief: Certain Transaction-Level Requirements for Non-U.S. Swap Dealers*, CFTC No-Action Letter No. 13-71 (Nov. 26, 2013); *Applicability of Transaction-Level Requirements to Activity in the United States*, CFTC Staff Advisory No. 13-69 (pub. avail. Nov. 14, 2013).

(vi) Court Finding on CFTC Cross-Border Guidance

On September 16, 2014, the U.S. District Court for the District of Columbia ("DC District Court") upheld the CFTC's (i) extraterritorial application of its swaps rules under Dodd-Frank and (ii) publication of its CFTC Cross-Border Guidance as interpretive guidance (rather than as a formal rulemaking).

However, the DC District Court found that the CFTC failed to appropriately consider the costs and benefits of the extraterritorial application of all of the swaps rules, with the exception of the large trader reporting, straight-through processing, and clearing determination rules. As such, the DC District Court found the CFTC's cost-benefit analyses arbitrary and capricious. The DC District Court did not find the deficiency "so serious" as to vacate the rules, and instead remanded the applicable rules to the CFTC to consider the costs and benefits of the substance of the rules in their extraterritorial application. As a result, all of the CFTC's swaps rules continue to apply in the cross-border context.

(d) EMIR and Cross-Border Guidance

The European Union has adopted a regulation on derivatives, central counterparties, and trade repositories, titled the European Market Infrastructure Regulation ("EMIR"). EMIR covers all OTC and exchange-traded derivatives ("ETD"), subject to a limited number of exemptions.

Under EMIR, the European Commission (on the advice of the European Securities and Markets Authority ("ESMA")) determines whether a third country's arrangements in respect of the risk mitigation rules that apply to the trading of OTC derivatives contracts, mandatory clearing of OTC derivative contracts with a central clearinghouse, and the reporting of OTC and ETD contracts to a third-party trade repository are "equivalent" to EMIR's requirements. Where a third country's rules are deemed to be equivalent, this will allow a party that is subject to both EMIR and the equivalent rules of the third country to be deemed to comply with the EMIR obligations by virtue of complying with the third country's rules. ESMA has conducted equivalence studies in respect of the United States, Japan, Hong Kong, Switzerland, Canada, and Australia. The European Commission has not yet adopted an equivalence decision for the regulatory regime of central counterparties in the United States, although it has now made such determinations in respect of other jurisdictions.

As a consequence, U.S. person funds may be directly subject to both Dodd-Frank and EMIR and may not have the benefit of relying on an equivalence determination under EMIR or a Substituted Compliance determination under Dodd-Frank, as applicable. For example, such a fund may have a majority of U.S. person investors, while being managed by an EU investment manager.

With respect to certain significant U.S. requirements, ESMA has provided technical advice to the European Commission as follows:[81]

Clearing. The CFTC and the European Commission have essentially identical processes to designate mandatory clearing obligations. EMIR equivalence permits a counterparty that is subject to EMIR to fulfil the clearing obligation by clearing under an equivalent third country regime. Assuming the European Commission finds the U.S. clearing requirement to be equivalent to that under EMIR, where an entity is subject to both U.S. and EU rules on clearing, it should be able to disapply the EU obligation provided the same product is cleared under the U.S. clearing regime.

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81 ESMA, Final report: Technical advice on third country regulatory equivalence under EMIR – US, September 1, 2013, ESMA/2013/1157.

Risk Mitigation. The CFTC and EMIR's risk mitigation provisions compare as follows:

(i) Timely confirmation – broadly equivalent.

(ii) Portfolio reconciliation – equivalent.

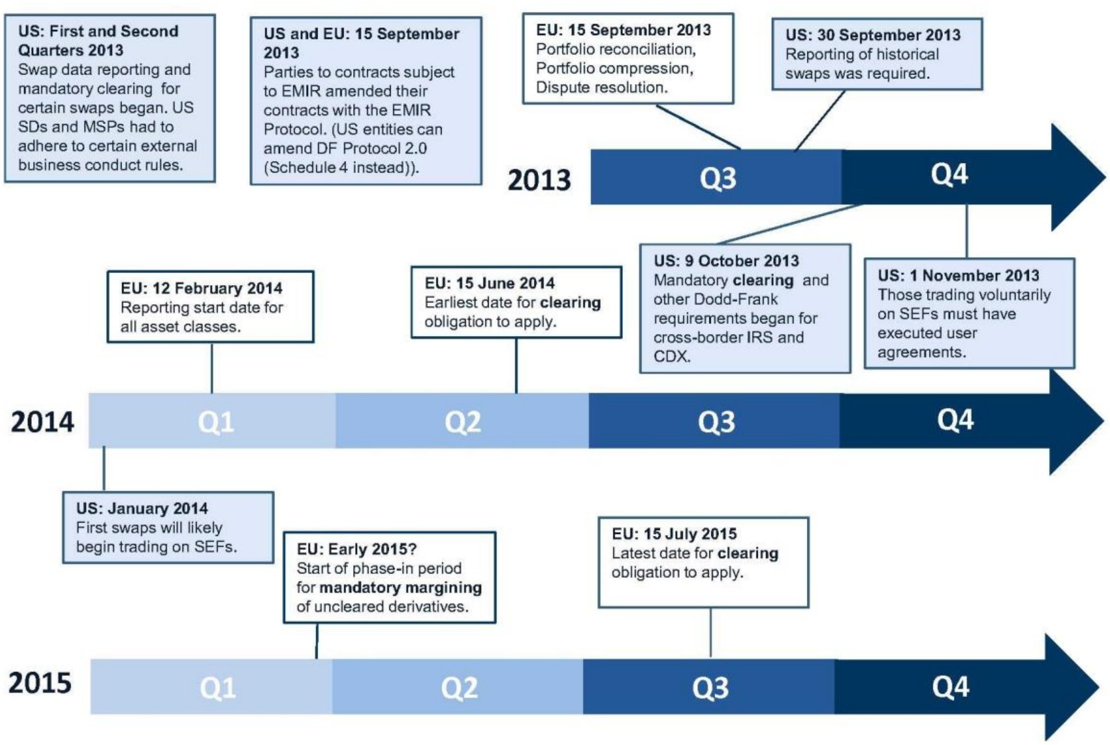
(iii) Portfolio compression – broadly equivalent.

(iv) Dispute resolution – not equivalent.

(v) Bilateral margining – to be confirmed, once rules are in place.

Reporting. The CFTC and EMIR rules were found not to be equivalent due to the fact there is no obligation under CFTC reporting to report data on the valuation of exposures and collateralization of exposures.

The EMIR reporting obligation and all the requirements under the risk mitigation rules, except for the rules in respect of margin procedures for OTC contracts, are now in force. ESMA has now published draft technical standards in respect of the clearing of interest rate derivatives, and these are also under review by the European Commission pending its approval. Further draft technical standards for the clearing of other derivative products are expected in 2015.



To facilitate EMIR compliance, ISDA has published two protocols: the ISDA 2013 EMIR NFC Representation Protocol ("NFC Protocol"); and the ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol ("EMIR Protocol"). The NFC Protocol allows counterparties to amend existing ISDA Master Agreements to reflect certain EMIR "know your counterparty" requirements.[82] The EMIR Protocol allows parties to amend ISDA Master Agreements and other derivatives agreements to comply with the portfolio reconciliation and dispute resolution requirements imposed by EMIR. The EMIR Protocol also includes a disclosure waiver that is intended to assist compliance with EMIR reporting and recordkeeping requirements without breaching parties' existing confidentiality agreements.[83]

Funds that are not otherwise directly subject to EMIR may still find they are required to comply with certain aspects of the EMIR obligations as a condition of trading with EU-based dealers. An EU-based dealer may require such a fund to inform the dealer of the fund's EMIR category so that the dealer can establish the extent to which the risk mitigation the clearing obligations apply.

A fund's applicable status or category under EMIR can be given to its counterparties via the NFC Protocol as described above, or alternatively through a representation made directly to an applicable dealer. The categorization can be: financial counterparty ("FC"); above threshold non-financial counterparty ("NFC+"); or below threshold non-financial counterparty ("NFC-"). The threshold refers broadly to whether gross notional amounts of positions in a particular class of derivatives exceeds certain defined amounts. It is not possible to determine definitively the EMIR categorization of a U.S. fund that is not managed by an EU-based investment manager. While the fund may appear to be an FC, the definition of an FC includes those entities which are regulated under one of the EU's financial regulatory regimes (such as those applying to banks, UCITS funds *(i.e.*, retail funds), or alternative investment funds (*i.e.*, private funds)). However, absent definitive guidance from an EU regulator, this cannot be confirmed with certainty, and such funds will have to assess their status as an FC or NFC subject to some uncertainty.

Those not directly subject to EMIR are not required to comply with the EMIR trade reporting obligation when trading with EU counterparties. However, the EU dealer remains subject to an obligation to report data in respect of itself and in respect of the trade entered into with such a non-EU counterparty, and in the course of such reporting will need to at least identify its counterparty via the reporting of such counterparty's Legal Entity Identifier (LEI).

V. CUSTOMER PROTECTION RULES

(a) Segregation of Customer Funds

The CFTC has adopted rules to address the treatment of customer collateral posted for cleared swaps, uncleared swaps, and futures contracts, options on futures, and commodity options. These rules require the segregation of customer funds within each of these types of accounts under different models, as discussed herein.

(i) Cleared Swap Accounts – LSOC Segregation Model

Under the "legal segregation with operational commingling" model ("LSOC Model"), all collateral for the cleared swaps customers of an FCM or DCO may be placed in one "omnibus" customer account of the

[82] *See* European Parliament and the Council, Regulation (EU) No 648/2012, July 4, 2012, on OTC derivatives, central counterparties and trade repositories (EMIR). The NFC Protocol is available on the ISDA website at http://www2.isda.org/functional-areas/protocol-management/protocol/11.

[83] The EMIR Protocol is available on the ISDA website at https://www2.isda.org/functional-areas/protocol-management/protocol/15.

FCM or a DCO.[84] However, the rules require the complete legal segregation of customer collateral from the FCM's or DCO's property. In the event of a clearing member FCM's bankruptcy, if there is a shortfall in the customer account that is attributable to a cleared swaps customer loss and the shortfall exceeds both the customer's collateral and the FCM's ability to pay, the DCO may only use the collateral attributable to the customers whose portfolios of positions at the DCO suffered losses (as well as the assets of the FCM itself) to meet the loss. In connection with the LSOC Model, an FCM must provide the relevant DCO with daily information regarding the identity of the FCM's underlying customers whose positions are held in the account, each customer's portfolio positions, and the margin associated with those positions.

Although central clearing of swaps and posting of collateral is intended to reduce systemic risk, it will not entirely de-risk the swaps market. The LSOC Model includes the following risks:

- Creating a potential single point of failure by using a central clearing organization.

- Posting collateral to a central counterparty makes that collateral potentially available to an FCM or DCO if one counterparty defaults.

- Creating contagion risk in that one party's default (including an FCM's) could spread and jeopardize all participants' cleared swaps collateral as a result of fraud, negligence, or operational mishap at the DCO, resulting in a shortfall in required collateral.

- Mutualizing risk to the extent that, if an FCM fails and there is a shortfall in required collateral, all cleared swap customers could face losses on a *pro rata* basis.

FCMs are generally not permitted to maintain margin for futures and options customer accounts in third-party custodial accounts, except in the case of FCMs that are ineligible to hold the assets of their registered investment company customers due to affiliation with the investment company or its adviser.[85] However, the CFTC does not impose a similar requirement on margin for cleared swaps, and an FCM may use a third-party custodial account for margin of cleared swap customers. The CFTC has stated that collateral in third-party accounts constitutes customer property within the meaning of the Bankruptcy Code, meaning that the customer posting margin via a third-party account may remain subject to the risk mutualization concerns discussed above.

Certain additional measures to prevent systemic risk arising out of the failure of a central counterparty (such as a DCO) as a result of clearing member default are currently being discussed in the market.[86] The potential measures being discussed are designed to allocate fully any uncovered losses and liquidity shortfalls in such an event. These measures include:

- "Variation margin haircutting," whereby the central counterparty would reduce *pro rata* the amount that the central counterparty would be obligated to pay participants with in-the-money (net) positions while continuing to collect in full from those participants with out-of-the-money (net)

[84] CFTC Regulations Part 22.

[85] Prior to 2005, the CFTC permitted a fund to enter into a tri-party control agreement with its FCM and custodian for the purpose of posting margin. In 2005, the CFTC issued an interpretative position to permit funds to place initial margin with an FCM (except in the case of a fund transacting with an affiliated FCM, which may still post margin pursuant to a control agreement). Amendment of Interpretation, 70 Fed. Reg. 24,768 (May 11, 2005).

[86] *See, e.g.*, Committee on Payment and Settlement Systems and Board of the International Organization of Securities Commission, Consultative Report, Recovery of Financial Market Infrastructures, August 2013, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD418.pdf.

positions. Losses, therefore, would be allocated to participants who have experienced a gain and have not contributed to a participant default.

- "Initial margin haircutting," whereby the central counterparty would write down initial margin provided by non-defaulting participants who then would be required to replenish their initial margin deposits with the central counterparty.

Margin haircutting is currently contemplated as being utilized only in situations where a clearing member defaults and all other safeguards, including the central counterparty's reserve fund, have been exhausted in an effort to avoid the central counterparty entering resolution proceedings.[87] Members of the U.S. buy-side community have voiced strong opposition to the concept of central counterparties utilizing collateral of non-defaulting clearing members to cover losses unrelated to such members to "recover" a central counterparty through margin haircutting.

(ii) Uncleared Swap Accounts – Election of Segregation

An SD and MSP must notify its uncleared swaps counterparty annually that the counterparty may elect segregation of its initial margin ("IM Seg") in an account maintained by a custodian independent of both the counterparty and the SD or MSP.[88]

Since the initial due date in 2014, many fund groups that already had collateral control agreements in place to transact in swaps while maintaining custody consistent with Investment Company Act's custody requirements have identified that their control agreements do not comply with certain provisions of the applicable CFTC regulations, meaning they would have to amend their collateral control agreements to elect IM Seg. These provisions include:

- CFTC Regulation 23.702, which requires that the control agreement provide for a penalty of perjury clause to be included in any "notice of exclusive control" or "pledgor access" provision; and

- CFTC Regulation 23.703(a), which provides that segregated margin may only be invested in certain liquid instruments consistent with the standards under CFTC Regulation 1.25.

(iii) Futures and Options Accounts – Segregation and Residual Interest Requirements

Under the segregation rules applicable to the commodity futures and options markets, FCMs must separately account for and segregate futures and options customer funds and property from the FCM's property but may operationally comingle funds and property of all customers.[89] Traditionally, following a default of both an FCM and one or more futures and options customers, the DCO would be permitted to access the collateral of non-defaulting customers before applying its own assets or the guaranty funds of non-defaulting FCM clearing members.

However, under rules adopted in October 2013, FCMs and DCOs must maintain "residual interest" in customer accounts to cover any deficits in these accounts.[90] The amount maintained must be at least equal

87 *See* ISDA, CCP Loss Allocation at the End of the Waterfall, August 2013, *available at* http://www2.isda.org/attachment/NTc5Nw==/CCP_loss_allocation_waterfall_0807.pdf.

88 CFTC Regulation 23.701-02.

89 CFTC Regulation 1.20.

90 *Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants*

to customers' aggregate undermargined amounts for the prior trade date (as discussed herein).[91] The rule also prohibits FCMs and DCOs from using the excess margin in one customer account to cover the deficit in another customer account.

Compliance dates for the residual interest requirement are being phased in over a five year period.

- Beginning November 14, 2014 – FCMs must post the required collateral by 6:00 p.m. (U.S. East Coast Time) on the date of settlement of the trade, which is the day after the trade occurs.

- Beginning December 31, 2018 – FCMs must post the required collateral at the time of settlement of the trade, which is the morning after the trade occurs.[92]

- Beginning November 14, 2014, FCMs are required to take a capital charge for failure to meet their residual interest requirements by the stated deadline.

(b) Investment of Customer Funds

Futures, Options and Cleared Swaps Accounts: Customer collateral may only be invested pursuant to CFTC Regulation 1.25.[93] Regulation 1.25 limits FCMs' investment of collateral posted in connection with cleared swaps and exchange-traded futures and options to specific, limited categories of enumerated "permitted investments."

Uncleared Swaps: Under rules adopted in October 2013, margin that swaps counterparties have elected to be segregated may only be invested in accordance with CFTC Regulation 1.25.[94]

(c) Other New Customer Protection Rules

The CFTC adopted a number of new rules that are designed to afford FCM customers greater protection, including:

- Monitoring of withdrawals from customer segregated or secured accounts.[95]

- New risk management programs and organizational requirements.[96]

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and Derivatives Clearing Organizations, 78 Fed. Reg. 68506 (Nov. 14, 2013).

91 CFTC Regulations 1.20(a) and 1.22.

92 The CFTC has proposed a revision to the December 31, 2018 deadline in CFTC Regulation 1.22. The amendment would remove the deadline for the phased-in compliance schedule for FCMs and provide assurance that the deadline would only be revised through a separate rulemaking. *Residual Interest Deadline for Futures Commission Merchants*, Commodity Futures Trading Comm'n (proposed Nov. 3, 2014), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister110314.pdf (to be codified at 17 C.F.R. pt. 1).

93 CFTC Regulations Part 22.

94 CFTC Regulation 23.703.

95 CFTC Regulation 1.23(d). An interpretation from the staff of the CFTC's DSIO indicates the view that FCMs are permitted to credit a customer's futures, foreign futures, and/or cleared swaps trading account for a margin payment upon the FCM's initiation of a withdrawal from the customer's bank account using the Automated Clearing House transaction system, subject to certain conditions. *Staff Interpretation Regarding Regulatory Accounting for Customer Margin Payments Using Automated Clearing House Payment Processing System*, CFTC Interpretation Letter No. 14-129 (Oct. 23, 2014).

- Enhanced reporting, recordkeeping, and disclosure rules.[97]
- New rules for self-regulatory organizations and certified public accountants.[98]
- Updates to FCM bankruptcy rules.[99]

(d) SEC Custody Requirements

Section 17(f) of the Investment Company Act requires a registered investment company to custody "securities and similar investments" with banks or, alternatively subject to certain rules of the SEC, broker-dealers or the fund itself. As a general matter, the SEC takes the position that margin or collateral is subject to Section 17(f) and that, absent relief thereunder, a fund must post margin or collateral with an eligible custodian.[100] SEC Rule 17f-6 under the Investment Company Act provides an exemption from Section 17(f) to allow registered investment companies to maintain initial margin in the custody of an unaffiliated FCM registered with the CFTC subject to certain conditions. Through a series of time-limited no-action letters, the SEC has extended Rule 17f-6 to cleared swaps, allowing funds or their custodians to satisfy margin requirements by placing margin in the custody of a DCO registered with the CFTC or a clearing member that is an FCM registered with the CFTC.[101]

VI. BLOCK TRADES

Dodd-Frank and CFTC regulations require the real-time reporting of swap transaction and pricing data.[102] Dodd-Frank also provides an exception to the real-time reporting requirement for certain large swaps by requiring the CFTC to establish "the criteria for determining what constitutes a large notional swap transaction (block trade) for particular markets and contracts" and "the appropriate time delay for reporting [such large trades] to the public."[103] On May 31, 2013, the CFTC published the minimum block trade sizes for different types of swaps that may be executed off-facility and with a time delay in public reporting.[104] If

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96 CFTC Regulations 1.11 and 1.16.

97 CFTC Regulations 1.12 and 1.55. The CFTC has issued an extension of no-action relief until December 31, 2014 to allow additional time for FCMs to obtain acknowledgement agreements from each depository that the FCMs use to hold customer funds. *Extension of Time Limited No-Action Position for Futures Commission Merchants Regarding Receipt of Acknowledgement Letters from Depositories*, CFTC No-Action Letter No. 14-127 (Oct. 16, 2014). The CFTC has extended no-action relief, pending the CFTC's consideration of the issues during a rulemaking process, for the requirement that FCMs simultaneously record book entry credits upon the receipt and recording of customer margin deposits to the CEA Section 4d(a)(2) funds accounts. *Extension of No-Action Relief from Compliance with Certain Conditions Associated with the Receipt of Customer Funds by Futures Commission Merchants Pursuant to Commission Regulations 1.20, 22.2, and 30.7,* CFTC No-Action Letter No. 14-131 (Oct. 30, 2014).

98 CFTC Regulation 1.52.

99 CFTC Regulation 190 to reflect cleared swaps, SEFs, and current swaps market practices.

100 *Custody of Investment Company Assets with Futures Commission Merchants and Commodity Clearing Organizations*, Investment Company Act Release No. 22389 (Dec. 11, 1996).

101 *See, e.g.,* Chicago Mercantile Exchange (Cash-Settled Commodity Index Swaps and Foreign Currency Swap Contracts) (pub. avail. Jul. 10, 2013); Chicago Mercantile Exchange (Credit Default Swaps and Interest Rate Swaps) (pub. avail. Dec. 26, 2013); ICE Clear Credit LLC (pub. avail. Dec. 26, 2013); LCH.Clearnet Limited and LCH.Clearnet LLC (pub. avail. Dec. 26, 2013).

102 CEA Section 2(a)(13).

103 CEA Section 2(a)(13)(E).

104 *Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block*

a swap is traded in a notional amount above a specified minimum size, the swap may be reported to the public on a delayed basis and need not be traded on a SEF or DCM.

Whether an investment adviser needs written consent from its clients and whether an investment adviser may aggregate the orders of various clients to meet the minimum order sizes to take advantage of this relief depends on whether the particular trade is classified as a "block trade" or a "large notional off-facility swap." In general, a block trade is a large trade that involves a swap that is listed on a SEF or DCM, which would have been executed on the SEF or DCM but for its large size and is otherwise executed pursuant to the SEF or DCM's rules and procedures.[105] A large notional off-facility swap is not subject to the rules and procedures of a SEF or DCM.

(a) Obtaining Client Consent

If the transaction is a large notional off-facility swap, no client consent is required. However, if the transaction is a block trade, the investment adviser will need to have an express consent from its clients in the applicable investment management agreements.[106] A general grant of investment management discretion is not adequate.[107]

(b) Aggregating Orders Across Multiple Clients

An investment adviser may aggregate the orders of multiple clients to reach the specified minimum notional size for block trades (but not for large notional off-facility swaps), provided that the following requirements are met:

(i) aggregation is permitted on the relevant SEF or DCM;[108]

(ii) the investment adviser has more than $25 million in assets under management;[109] and

(iii) the investment adviser is:

(A) a registered or exempt CTA which has discretionary trading authority or directs client accounts,[110]

Trades; Final Rule, 78 Fed. Reg. 32866, 32870 (May 31, 2013) ("Block Trade Adopting Release").

105 Under CFTC Regulations, a block trade must "occur away" from a registered SEF's or DCM's trading system or platform in order for the block trade to be eligible for the delay from public reporting. However, SEFs have determined that block trades must be submitted to SEFs in order to facilitate certain required credit checks prior to execution because technology does not yet exist to conduct such checks if the trades are not submitted to the SEF. To reconcile this conflict, the CFTC Staff issued no-action relief that allows market participants to employ the block trade reporting time delay even though the trade was submitted to SEFs to conduct the pre-execution checks. This relief will expire on December 15, 2015. See *No-Action Relief for Swap Execution Facilities from Certain "Block Trade" Requirements in Commission Regulation 43.2*, CFTC No-Action Letter No. 14-118 (Sept. 19, 2014).

106 CFTC Regulation 43.6(i)(2).

107 Block Trade Adopting Release, at 32906.

108 CFTC Regulation 43.6(h)(6).

109 CFTC Regulation 43.6(h)(6)(ii).

110 CFTC Regulation 43.6(h)(6)(i)(A).

(B) a registered investment adviser ("RIA") which has discretionary trading authority,[111] or

(C) a foreign equivalent to a CTA or RIA.[112]

In addition, the aggregated orders must be executed as a single swap order and may not be aggregated after they have been executed.[113] Furthermore, while CFTC regulations do not expressly require client consent for aggregating positions with other clients in order to reach the minimum block trade size, the adopting release to those regulations suggests that such consent must be obtained.[114]

VII. POSITION LIMITS

Dodd-Frank expanded the CFTC's jurisdiction over speculative position limits in the commodity markets to include, in addition to futures and options contracts, swaps traded on a DCM or SEF as well as swaps that are economically equivalent to futures and options contracts traded on a DCM or SEF.[115]

On November 18, 2011, the CFTC published a comprehensive set of regulations on position limits on exchange-traded futures and options contracts and economically-equivalent OTC derivatives referencing 28 individual agricultural, metal, and energy commodities.[116] The regulations also required market participants to aggregate position limits across accounts and positions that they control, subject to certain exceptions. On May 30, 2012, the CFTC published proposed modifications to its policy for aggregation under these revised position limits regulations to clarify and expand certain exemptions from aggregation ("May 2012 aggregation proposal").[117] However, on September 28, 2012 the CFTC's revised position limit regulations were vacated by the DC District Court and remanded to the CFTC.[118]

On November 5, 2013, the CFTC proposed a new set of position limit regulations and aggregation standards.[119] The new proposal is substantively similar to the vacated regulations and the May 2012 aggregation proposal, but differs in a number of important respects. For example, the new proposal modifies the types of transactions eligible for an exemption from position limits for *bona fide* hedging (such as by narrowing the types of eligible "anticipatory hedges") and adds a significant exemption to position limits in the spot month for traders who hold only cash-settled contracts in a given commodity. The proposal also expands upon the circumstances under which aggregation is not required. The comment period on the proposal ended on February 10, 2014, but the CFTC re-opened the comment period from June

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111 CFTC Regulation 43.6(h)(6)(i)(B).

112 CFTC Regulation 43.6(h)(6)(i)(C).

113 *No-Action Relief for Certain Commodity Trading Advisors and Investment Advisors From the Prohibition of Aggregation Under Regulation 43.6(h)(6) for Large Notional Off-Facility Swaps*, CFTC No-Action Letter No. 13-48 Amended (Aug. 6, 2013), at 3.

114 Block Trade Adopting Release, at 32906.

115 CEA Sections 4a(a)(2) and 4a(a)(5).

116 *Position Limits for Futures and Swaps; Final Rule and Interim Final Rule*, 76 Fed. Reg. 71626 (Nov. 18, 2011) (codified at 17 C.F.R. pts. 1, 150, 151).

117 *Aggregation, Position Limits for Futures and Swaps; Proposed Rule,* 77 Fed. Reg. 31767 (May 30, 2012).

118 ISDA v. U.S. Commodity Futures Trading Comm'n, 887 F. Supp. 2d 259 (D.D.C. 2012).

119 *Position Limits for Derivatives; Proposed Rule*, 78 Fed. Reg. 75679 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 1, 15, 17, 19, 32, 38, 140, 150); *Aggregation of Positions; Proposed Rule*, 78 Fed. Reg. 68946 (Nov. 15, 2013) (to be codified at 17 C.F.R. pt. 150).

12, 2014 until August 4, 2014 in connection with a public roundtable held by the CFTC Staff on June 19, 2014 to consider certain issues regarding position limits for physical commodity derivatives.

(a) Setting Position Limits

The formulas for calculating position limits in the proposed regulations are substantially similar to those in the vacated regulations, and position limits will be set with the following procedure:

- Spot-month position limits are to be set no higher than 25% of the estimated spot-month deliverable supply of a referenced commodity, with initial limits to be set at the levels currently in place at DCMs. Spot-month limits will be applied separately for physical-delivery contracts and cash-settled contracts, and traders will not be permitted to net positions across those two categories of contracts for purposes of complying with the spot-month limits.

- Non-spot-month contracts (*i.e.*, both single-month and all-months-combined) position limits will be set using a "10/2.5 percent formula" with a limit equal to: 10 percent of the estimated average interest in open contracts of the referenced commodity, up to 25,000 contracts, plus 2.5 percent of further open interest. The proposed regulations permit netting across physical-delivery and cash-settled contracts for non-spot-month position limits.

The proposed regulations provide a "conditional spot-month limit exemption" that permits traders to acquire cash-settled spot-month positions in any referenced commodity at a level five times greater than the spot-month limit if such positions are exclusively in cash-settled contracts, subject to certain requirements. The vacated regulations, by contrast, provided a similar spot-month limit exception, but that exception was only available for certain natural gas contracts.

(b) Exemptions to Position Limits

As with the prior vacated regulations, contracts entered into in good faith prior to the effective date of the final regulations would not be subject to the proposed "single-month" or "all-months-combined" position limits, but the "spot-month" position limits would apply to pre-existing positions. Diversified commodity index contracts are expressly excluded from the scope of these regulations.

The *bona fide* hedging exemption under current CFTC regulations would be changed under the proposed regulations. Specifically, the proposed regulations expand certain existing types of *bona fide* hedging, remove exemptions for certain types of anticipatory hedging, and, consistent with the vacated regulations, limit the *bona fide* hedging exemption to specifically-enumerated hedging transactions. Additionally, the proposed regulations eliminate the existing process for seeking a non-enumerated exemption for *bona fide* hedging, which limits traders to either request an interpretive letter from the CFTC Staff or resort to the CFTC's general exemptive authority under the CEA.

(c) Aggregation of Positions

The proposed aggregation regulations, consistent with current CFTC regulations and the CFTC's May 2012 aggregation proposal, generally require a person to aggregate all positions for which the person has trading control and all positions in which the person has a 10 percent or greater ownership interest, unless an exception applies. The proposed aggregation regulations expand the available exceptions to aggregation by adding four new situations in which positions need not be aggregated:

1. Where the sharing of information necessary to aggregate positions "would violate or create reasonable risk of violating U.S. Federal or state or foreign jurisdiction law or regulation" (subject to a notice filing with a memorandum of law explaining the reason for the exemption).

2. Where the market participant has an ownership interest equal or exceeding 10 percent but less than 50 percent in another entity, but such other entity's trading is independently controlled (subject to a notice filing and certain conditions).

3. Where (i) the market participant has an ownership interest of greater than 50 percent in another entity, (ii) the CFTC finds, in its discretion, that (among other things) the other entity is not consolidated with the applicant under U.S. generally accepted accounting principles, the other entity's trading is independently controlled, and the applicant certifies to the CFTC in a notice filing that the other entity's positions qualify as *bona fide* hedging positions or do not exceed 20 percent of any applicable position limit, provided that the market participant complies with certain other conditions.

4. Where the market participant has an ownership interest in another entity as the result of either an ownership in securities constituting an unsold allotment to or subscription by such person in a distribution of securities by an issuer or underwriter, or broker-dealer activities in the normal course of business as a dealer.

The proposed regulations also modify the exemption from the position limit regime for "independent account controllers" ("IACs"), the required attributes of which are specified in the CFTC regulations.[120] The IAC concept is a long-permitted exemption from aggregation under the CFTC's position limit regulations and is generally the most important exemption for asset managers. Under the IAC exemption, certain eligible persons (including registered or excluded CPOs or CTAs to registered investment companies and other types of funds)[121] that would ordinarily be required to aggregate all commodity interest positions in accounts or pools under their ownership or control are exempt from such aggregation if they delegate trading authority over those accounts or pools to an IAC that independently controls trading decisions without the day-to-day direction of the delegator (provided that certain other conditions are satisfied). Among other things, the proposed changes to the IAC definition extend the IAC concept to treat an investment manager of an employee benefit plan sponsored by a corporate entity as an IAC, thus permitting the sponsoring entity to avoid aggregating the positions of the plan with its other trading activities.

These changes apply to the CFTC's existing position limit regulations as well as the CFTC's May aggregation 2012 proposal.

[120] CFTC Regulation 150.1(e).

[121] CFTC Regulation 150.1(d).

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