Transitioning to the New Swap Regulatory Framework: Current and Upcoming Challenges*

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I. INTRODUCTION AND OVERVIEW OF DODD-FRANK

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 codifies 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 ("swap dealers") and certain large OTC swap participants ("major swap participants");

- requiring swap dealers and major swap participants 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 swap dealers and certain swap activities related to *bona fide* hedging and traditional bank activities.

Certain regulations promulgated by the CFTC under Dodd-Frank can be conceptually divided into entity-level requirements which apply to certain market participants without distinction as to the counterparty or location of the swap, and transaction-level requirements that apply to each swap.

- "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).

- "Transaction-Level Requirements" relate to: (i) clearing and swap processing; (ii) margining (and segregation) for uncleared swaps; (iii) trade execution; (iv) swap trading 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.

Certain portions of Title VII remain subject to further rulemaking by the SEC and the CFTC.

II. JURISDICTION UNDER TITLE VII

Dodd-Frank allocates jurisdiction over the derivatives markets between the SEC for "security-based swaps" and certain participants in the security-based swap markets and the CFTC for all other "swaps" and certain participants in the swap markets. The SEC is the regulatory authority responsible for imposing new capital and margin requirements on security-based swaps, such as equity swaps, forwards, and options, and 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).

(a) Derivative 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.

Derivatives Contract	Commodity	Security
Commodity futures including security futures (on single stocks, narrow-based securities indices,[3] and broad-based securities 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, single loans (non-security loans),[4] or narrow-based security indices		**X**
Swaps on broad-based securities indices	**X**	

(b) Swaps vs. Non-Swaps

Dodd-Frank broadens the definition of "swap" and places swaps under CFTC jurisdiction. The charts below provide examples of swaps and non-swaps under Section 1a(47) of the U.S. Commodity Exchange Act as amended ("CEA") and the CFTC regulations thereunder.

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

2 Section 2(a)(1) of the U.S. Securities Act of 1933 as amended and Section 3(a)(10) of the U.S. Securities Exchange Act of 1934 as amended ("Exchange Act").

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

4 "Depending on the facts and circumstances loans may be notes or evidences of indebtedness that are securities" under Section 3(a)(10) of the Exchange Act. *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) (citing Section 3(a)(10) of the Exchange Act). A security-based swap is defined in CEA Section 1a(42) and Exchange Act Section 3(a)(68).

Financial Product	Swap	Non-Swap
Foreign Exchange Products:		
Foreign Exchange Forwards[5]		**X**
Foreign Exchange Swaps[6]		**X**
Foreign Currency Options	**X**	
Retail Foreign Currency Options		**X**
Non-Deliverable Forward Contracts Involving Foreign Exchange	**X**	
Currency Swaps and Cross- Currency Swaps	**X**	
Foreign Exchange 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	**X**	

Although not generally regulated as swaps, certain non-swaps (including physically-settled foreign exchange swaps and foreign exchange 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.[8]

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	**X**	

5 Under CEA Section 1a(24), a "foreign exchange 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), a "foreign exchange 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."

7 Under CEA Section 1a(47)(D), a "mixed swap" is a security-based swap that is also "based on the value of one 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 *Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act*, 77 Fed. Reg. 69694, 69699 (Nov. 20, 2012); CEA Sections 1a(47)(E) and (F)(ii).

Financial Product	Additional Information	Swap	Non-Swap
	connection with the position.		
Insurance Products	Must meet "Product Test"[9] and "Provider Test"[10] to be considered insurance and not swaps. Those products listed as "Traditional Insurance Products" must be provided in accordance with the Provider Test.		**X**
Consumer Transactions	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 (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**

[9] 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
- 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).

[10] 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).

Financial Product	Additional Information	Swap	Non-Swap
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 OF TITLE VII AND RELATED ISSUES

(a) 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."[11] The CFTC has adopted Regulation 50.2 to implement the CEA clearing requirement. Timing of any clearing obligation depends on (i) authorization of clearinghouses and (ii) authorization of products for clearing. Currently there are 13 registered DCOs (*i.e.*, clearinghouses) and three 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.[12]

- A DCO must submit to the CFTC for prior approval any group, category, type, or class of swaps the DCO seeks to clear.[13] The CFTC is required to respond to any such DCO request within 90 days of submission of the request.[14]

- 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.[15]

In making these determinations, the CFTC will review all relevant facts and circumstances, issue a public report containing the results of the determination within 30 days of its completion, and take any action the CFTC determines necessary and in the public interest.[16] To be cleared, a product must be on standard terms, trade in volume, and be sufficiently liquid.

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11 CEA Section 2(h).

12 CEA Section 2(h)(2).

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

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

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

16 CFTC Regulation 39.5(c)(i)-(iii).

(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.[17] 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.[18]

- 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.[19]

(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 swap dealers, registered major swap participants, and active funds.[20] 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, 2014).

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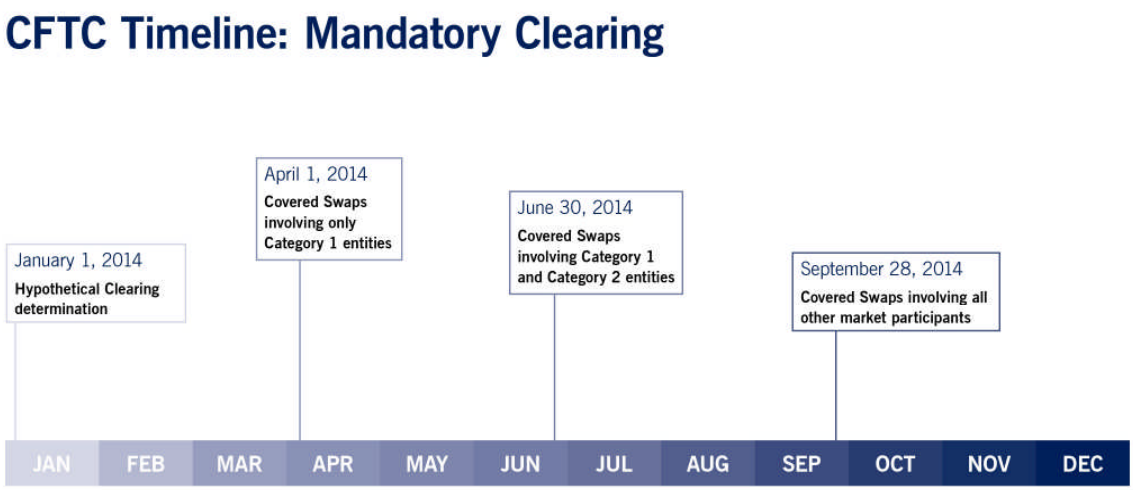
17 *Clearing Requirement Determination Under Section 2(h) of the CEA; Final Rule*, 77 Fed. Reg. 74283 (Dec. 13, 2012); CFTC Regulation 50.4.

18 CFTC Regulation 50.4(a).

19 CFTC Regulation 50.4(b).

20 An "active fund" is any private fund as defined in Section 202(a) 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.

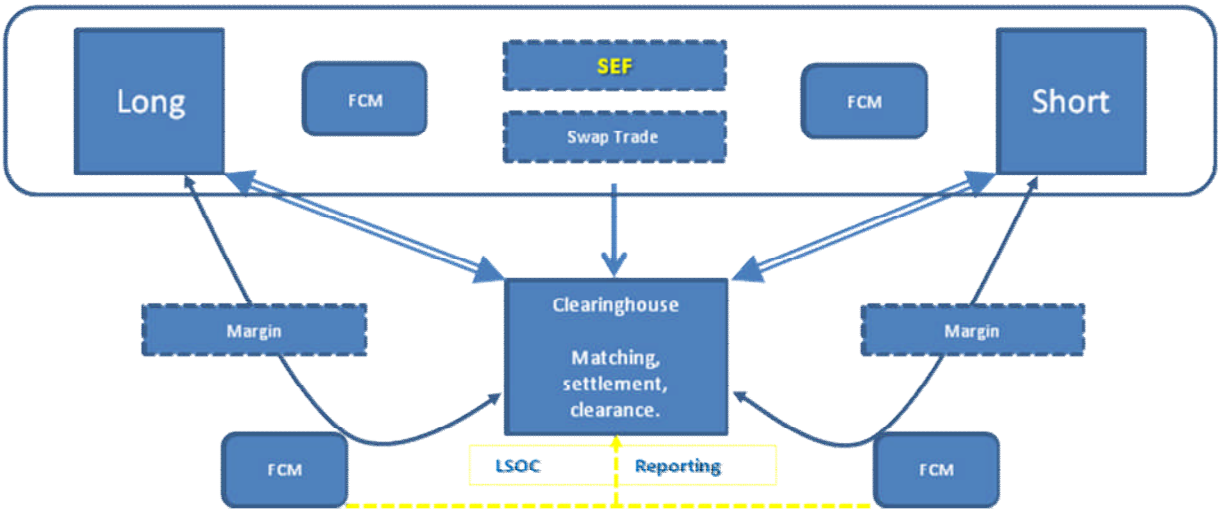


(iv) Clearing Process

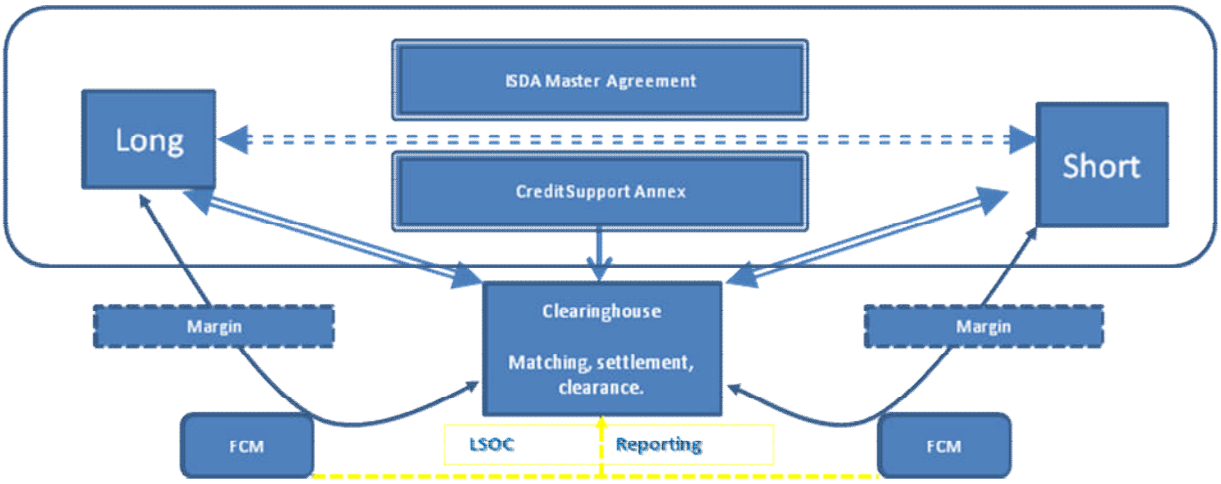
Cleared swaps may be exchange traded or traded bilaterally OTC. Futures commission merchants ("FCMs") facilitate clearing of both exchange-traded and bilateral OTC swaps. An FCM is an individual or organization that (i) solicits or accepts orders to buy or sell futures contracts, options on futures contracts, commodity options, retail off-exchange forex contracts, or swaps, and (ii) accepts money or other assets from customers to support such orders.[21]

For an *on-exchange swap transaction*, a party executes a swap with another party on an exchange either directly (as a swap execution facility ("SEF") member) or through an FCM. 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.

[21] CEA Section 1a(28).



For an *OTC cleared swap transaction*, the buy-side participant (*e.g.*, a fund) and a swap dealer or other permissible counterparty execute a swap OTC directly and bilaterally and document the swap transaction under an International Swaps and Derivatives Association ("ISDA") Master Agreement. Following execution, the parties "give up" the swap transaction for clearing through their respective clearing member FCMs. As in an on-exchange swap, after 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. 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 requires 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.

(b) 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 "contract market" ("DCM") (*i.e.*, historically, a futures 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).[22] Prior to the effectiveness of Title VII, many market participants utilized electronic trading systems and platforms to execute swaps and many such platforms fall within the CEA's definition of a SEF. As a result, these systems and platforms are subject to registration and regulation as SEFs. However, given the time involved in implementing the SEF-related provisions of the CEA, the CFTC permitted these platforms to continue to operate on an unregulated basis after the general effective date of Title VII until the CFTC adopted final rules governing their operations.[23]

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.[24] The SEF Final Rules require SEFs to register with the CFTC and to comply with CFTC regulations beginning October 2, 2013 (although the compliance date for SEF core principals was delayed until November 1, 2013).[25] As a result, many trading systems and platforms that operated in an unregulated capacity pursuant to the SEF Order (and the amendments thereto) and the CFTC no-action letters extending the SEF compliance dates[26] are now required to operate as registered and regulated SEFs.

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22 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.

23 *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).

24 *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 principals under Section 5(d) of the CEA.

25 *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).

26 *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).

(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.[27]

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;
- the bid/ask spread; and
- the usual number of resting firm or indicative bids and offers.[28]

A DCM or SEF may only submit its determination to initiate the CFTC's MAT determination process for a swap (i) that lists for trading and (ii) that is subject to mandatory clearing.[29] Once the DCM or SEF makes its initial determination, the DCM or SEF must then submit its determination to the CFTC for approval as described in CFTC Regulation 40.5 or self-certification as described in CFTC Regulation 40.6. During the CFTC's review process, market participants may provide comments to the CFTC regarding the MAT determination.

Once the CFTC approves a transaction as made available to trade or the transaction is deemed certified as available to trade, then all other DCMs and SEFs that list or offer that swap for trading must do so in accordance with the trade execution requirements.

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 on August 5, 2013, and the first determination was submitted on October 19, 2013 under CFTC Regulation 40.6(a) and is

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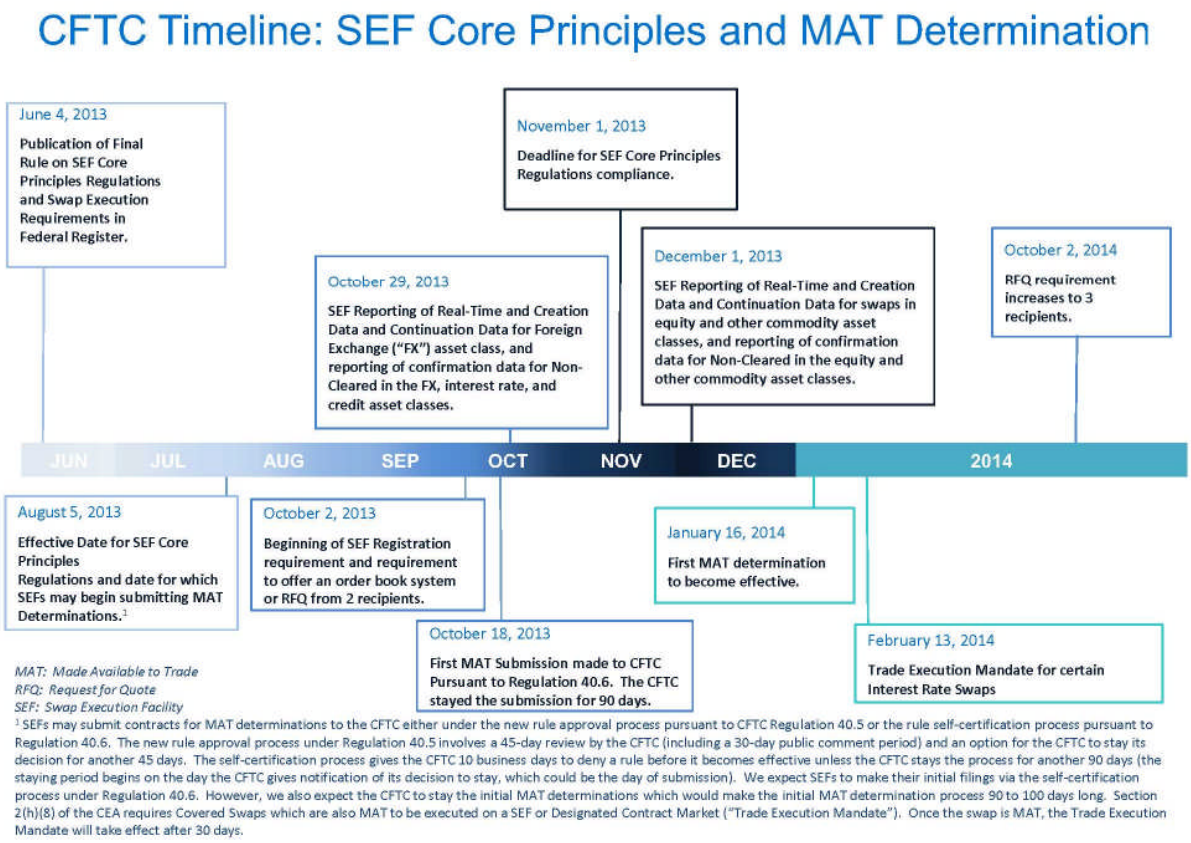
[27] *Process for a Designated Contract Market or Swap Execution Facility to Make a Swap Available to Trade, Swap Transaction Compliance and Implementation Schedule, and Trade Execution Requirement Under the Commodity Exchange Act*, 78 Fed. Reg. 33606 (Jun. 4, 2013).

[28] CFTC Regulations 37.10 and 38.12.

[29] 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.

currently subject to a 90 day review period.[30] The following chart depicts the CFTC's timeline for implementing its initial MAT determination and the SEF Final Rules.



(iii) 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.[31] 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.[32]

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

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30 *Javelin Determination of Made Available to Trade of Certain Interest Rate Swaps made Pursuant to Parts 37 of the Rules of the Commodity Futures Trading Commission*, Submission No. 13-06 (Oct. 18, 2013).

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

32 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.

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. Compliance with these requirements began November 1, 2013.[33]

Market participants should review SEF rulebooks and user agreements carefully and establish appropriate procedures to ensure compliance with applicable SEF rules. While the particulars of each rulebook and user agreement vary by SEF, as a general matter a rulebook requires participants to adopt appropriate procedures to ensure compliance with the SEF's rules and to supervise the participant's traders who utilize the platform. These documents also generally, among other things: (i) limit the liability of a SEF arising from a participant's use of the SEF; (ii) impose criteria that participants and their traders must satisfy in order to utilize a SEF; (iii) grant a SEF the authority to revoke a participant's access to the SEF; (iv) authorize a SEF to impose fines and take other disciplinary actions against a participant in certain instances; and (v) require a participant to consent to a SEF's jurisdiction. Market participants will generally be required to have agreed to the rules of a SEF prior to utilizing that SEF to execute swap transactions.

The following are examples of rulebook requirements and provisions that funds should consider before agreeing to the rules of a SEF:

- broad limitations on the liability of a SEF and its contractors arising from a participant's use of the SEF, in some cases regardless of the fault of the SEF or its contractor;
- imposition of criteria that participants and their traders must satisfy in order to utilize a SEF, which are often broad and vaguely worded (*e.g.*, the participant must be "of good reputation and business integrity" and "maintain adequate financial resources and credit," and authorized traders must be "technically proficient");
- grant to the SEF the authority to revoke a participant's or authorized trader's access to the SEF for any reason and without prior notice in some instances;
- grant to the SEF the authority to suspend a participant's trading privileges if a clearing member rejects a swap;
- authorization of the SEF to impose fines and take other disciplinary actions against a participant in certain instances, sometimes without any procedure to appeal;
- fines of $1,000,000 or higher;
- requirements that the participant consent to a SEF's jurisdiction;
- requirements that the participant disclose certain information or the occurrence of certain events to the SEF immediately;

[33] *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).

- requirements that the participant has reasonable procedures to ensure that authorized traders comply with applicable laws and the SEF rulebook; and

- "enablement mechanisms," which prevent a market participant from interacting or trading with, or viewing the bids and offers displayed by, other market participants on a SEF. Note that the CFTC has recently issued guidance that such restrictions are in violation of CFTC Regulation 37.202.[34]

(iv) Other Requirements Applicable to SEF Members

In addition to the requirements imposed by SEF user agreements and rulebooks, market participants should also note additional CFTC regulations applicable to SEF members, such as recordkeeping rules in CFTC Regulations 1.35 and 1.31.

(c) 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. In CEA Section 2(a)(13)(E), Dodd-Frank 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.

Under the CFTC's swap transaction data reporting rules that implement these CEA sections, two main categories of data must be reported to an SDR: (i) swap creation data, which consists the swap's primary economic terms ("PET") and confirmation data; and (ii) swap continuation data, which consists of valuation and life cycle event data.[35]

On November 20, 2013, the CFTC made certain data publicly available when it issued the first Weekly Swaps Report ("Report").[36] The Report includes the gross notional outstanding value, the weekly transactions measured by dollar volume, and the weekly transactions measured by ticket volume for IRS and CDS. The Report further provides detailed breakdowns of the swap markets

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[34] CFTC, *Guidance on Application of Certain Commission Regulations to Swap Execution Facilities* (Nov. 14, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/dmostaffguidance111413.pdf.

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

[36] *CFTC Announces Weekly Swaps Report*, Release: PR6780-13 (Nov. 20, 2013), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6780-13. The Report is available at http://www.cftc.gov/MarketReports/SwapsReports.

by product type, currency, tenor, participant type, and cleared or uncleared swaps for each asset class. The Report showed that, as of November 8, 2013, the outstanding notional amount totals were $320 trillion for IRS (61% of which were cleared) and $9.1 trillion for CDS (23% of which were cleared).[37]

(ii) Duty to Report

Non-swap dealer and non-major swap participants 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:

- 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.[38]

(d) Proposed Margin Requirements for Uncleared Swaps

Dodd-Frank requires the adoption by the CFTC and 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, the U.S. Farm Credit Administration, and the U.S. Federal Housing Finance Authority (collectively "prudential regulators") of margin requirements for uncleared derivatives.[39] These requirements have not yet been adopted as final by any regulator. Currently, there are three outstanding regulatory frameworks from (i) the CFTC, (ii) the SEC, and (iii) the prudential regulators. The Basel Committee on Banking Supervision and the International Organization of Securities Commissions ("BCBS/IOSCO") have also released a policy framework intended to establish minimum requirements to guide various regulators in establishing margin rules.

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37 *Id.*

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

39 Dodd-Frank Section 764.

(i) CFTC Margin Proposal

The CFTC's proposed margin rules would apply to, and require margin collection by, all swap dealers and major swap participants that are not prudentially regulated.[40] The proposed rules contemplate different requirements depending on the category of the counterparty, as follows:

- Swap dealers and major swap participants are proposed to be required to collect and pay initial and variation margin for transactions with other swap dealers or major swap participants.

- Swap dealers and major swap participants are proposed to be required to collect initial and variation margin from a counterparty that is a Non-SD/MSP and is a financial entity, but are not proposed to be required to pay margin to such a counterparty.

- Commercial end-users—defined as non-financial entities under the proposed margin rules—would not be subject to margin requirements but would be required to enter into credit support arrangements with the counterparty, and the swap dealer/major swap participant would be required to calculate hypothetical initial and variable margin amounts to serve as risk management tools to measure exposure.

The proposal would only apply to uncleared swaps entered into after the effective date of the final rule.

Any type of collateral could be used as margin by non-financial entities, subject to the credit support agreement, as long as the value of the collateral could be reasonably ascertained. In transactions between a swap dealer or major swap participant and another swap dealer or major swap participant or a Non-SD/MSP financial entity, only cash, U.S. obligations, or certain senior debt obligations of government entities could be used for initial margin, and only cash or U.S. Treasury securities could be used for variation margin.

For transactions between a swap dealer or major swap participant and another swap dealer or major swap participant, initial margin must be held by a custodian. While not required for transactions between a swap dealer or major swap participant and a Non-SD/MSP, the swap dealer/major swap participant must permit the Non-SD/MSP to elect to have initial margin held by a custodian.

(ii) SEC Margin Proposal

The SEC's proposed margin rules would apply to security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs").[41] The proposal would require:

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40 *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 23732 (proposed Apr. 28, 2011) (to be codified at 17 C.F.R. pt. 23).

41 *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, 77 Fed. Reg. 70214 (proposed Nov. 23, 2012) (to be codified at 17 C.F.R. pt. 240). SBSDs and MSBPs are generally the counterparts to swap dealers and major swap participants that trade SEC-regulated products.

- 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.

(iii) Prudential Regulator Margin Proposal

Dodd-Frank requires a swap dealer, major swap participant, SBSD, or MSBSP that, in lieu of being regulated by the CFTC or 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 entities to meet CFTC and SEC margin requirements. The prudential regulator proposal would require unilateral margin collection by all swap dealers, major swap participants, SBSDs, and MSBSPs, and it would require all OTC swap counterparties to post margin.[42] Non-SD/MSP/SBSD/MSBSP counterparties are further divided into three categories: high-risk financial end-users, low-risk financial end-users, and non-financial end-users. These classifications affect whether initial margin thresholds may be used and the amounts of those thresholds. The proposal would apply both to swaps and security-based swaps entered into 180 days after the publication of the rules.

Under the proposal, only the following could be used as collateral: cash, U.S. obligations, or debt obligations of certain government entities. For transactions between a swap dealer/major swap participant/SBSD/MSBSP and another swap dealer/major swap participant/SBSD/MSBSP, initial margin must be held by a custodian. The proposal does not include custodial requirements for transactions involving other counterparties.

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[42] *Margin and Capital Requirements for Covered Swap Entities*, 76 Fed. Reg. 27564 (proposed May 11, 2011) (to be codified at 12 C.F.R. pt. 45, 237, 324, 624, 1221).

(iv) 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 intended to establish minimum requirements to guide regulators in G20 nations in the adoption of margin rules for non-cleared derivatives.[43]

This framework applies beyond swaps and security-based swaps to cover all non-cleared derivative transactions. All participants 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 non-cleared derivatives. 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 derivative counterparty. The framework requires margin to be held in a manner that protects the posting party in the event the collecting party enters bankruptcy but permits rehypothecation under certain circumstances and subject to a series of protective limitations.

(e) Trading Documentation

(i) Clearing Agreements and Related Documentation

FCMs generally document clearing relationships with their clients using a futures and options account agreement and a "cleared derivatives addendum" published by the Futures Industry Association ("FIA") and ISDA ("Cleared Derivatives Addendum"). The Cleared Derivatives Addendum is a template for FCMs and their customers to document their 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 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.

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

- Required notice periods prior to imposition of additional margin cushion requirements by 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 guidance in Rule 17f-6 under the U.S. Investment Company Act of 1940 as amended.[44]

- 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.[45]

- 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 FCM upon FCM insolvency.[46]

(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 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

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44 SEC Reg. 17f-6(a)(2).

45 Although Rule 2-27 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.

46 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).

activities. The ISDA Dodd-Frank Protocols attempt to streamline the regulatory compliance process for dealers and their counterparties.

There are currently two ISDA Dodd-Frank Protocols: 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 external business conduct standards ("Business Conduct Rules") (also known as the Category B Transaction-Level Requirements),[47] while Protocol 2.0 is aimed to facilitate compliance with certain Category A Transaction-Level Requirements, described in greater detail herein.[48] 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 the dealer's compliance with the Business Conduct Rules, Protocol 1.0 facilitates the delivery of extensive "know your customer" information from the counterparty to the dealer.[49] Additional disclosure is required for ERISA or other "Special Entities" as defined in the CFTC regulations.[50]

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 dealer of any material change in information.[51]
- To promptly provide the dealer with "any information reasonably requested" to enable the dealer to comply with Dodd-Frank and related CFTC regulations.[52]
- To report certain "life cycle events" on the second business day following the day on which they occur.[53]
- 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.[54]

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

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

49 ISDA August 2012 DF Supplement Schedule 2.

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

51 ISDA August 2012 DF Supplement Section 2.3.

52 ISDA August 2012 DF Supplement Section 2.4.

53 ISDA August 2012 DF Supplement Section 2.10.

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

B. Protocol 2.0

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

- *Portfolio Reconciliation*: Provides a framework for meeting the portfolio reconciliation and dispute resolution requirements in Dodd-Frank.[55] 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.[56]

- *Swap Trading Relationship Documentation*: Dealers must have documentation in place documenting the terms that govern the trading relationship with counterparties.[57]

- *Valuation and Dispute Resolution*: Protocol 2.0 specifically covers valuation and dispute resolution, while other terms will typically be found in swap confirmations.[58]

- *End-User Exception*: Dodd-Frank provides an exception from mandatory clearing if a customer qualifies as an "end-user."[59] Protocol 2.0 contains a number of representations for dealers to obtain the information needed to ensure regulatory compliance in lieu of clearing with these counterparties.[60] This generally does not apply to funds.

C. ISDA 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.[61] 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. ISDA Cross-Border Swaps Representation Letter

On August 19, 2013, ISDA published its "Cross-Border Swaps Representation Letter."[62] This letter is designed to allow swap counterparties to make representations to their swap dealers to assist swap dealers with determining whether the CFTC will assert jurisdiction over the swap

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55 ISDA March 2013 DF Supplement Schedule 4.

56 CFTC Regulation 23.502(b)(3).

57 ISDA March 2013 DF Supplement Section 2.4.

58 ISDA March 2013 DF Supplement Schedule 3.

59 CFTC Regulation 50.50.

60 ISDA March 2013 DF Supplement Sections 2.9-2.11.

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

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

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" (as defined by the CFTC). 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.

IV. CROSS-BORDER GUIDANCE AND U.S. PERSON DEFINITIONS

(a) CFTC Cross-Border Guidance and U.S. Person Definition

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 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.

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 ("Guidance").[63] Among other things, the 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. This U.S. person definition will be used by swap dealers and major swap participants in determining the U.S. requirements applicable to swap transactions and relationships with such persons.[64]

(i) CFTC 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 swap activities satisfy the CEA jurisdictional nexus. The 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

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63 *Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations*, 78 Fed. Reg. 45292 (Jul. 26, 2013)("Guidance"). The CFTC also adopted an exemptive order providing temporary conditional relief from compliance with certain provisions of the Guidance for certain entities subject to the CFTC's definition of U.S. person ("Exemptive Order"), which delayed compliance with certain parts of the Guidance. *Exemptive Order Regarding Compliance with Certain Swap Regulations*, 78 Fed. Reg. 43785 (Jul. 22, 2013).

64 The CFTC does not intend for the 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").

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."

(ii) Transactions with Non-U.S. Person Swap Dealers

The Guidance provides that Transaction-Level Requirements do not apply to transactions between a non-U.S. person swap dealer/major swap participant and another non-U.S. person. However, the staff of the CFTC's Division of Swap Dealer and Intermediary Oversight has issued an advisory providing that a non-U.S. swap dealer (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.[65] The compliance date will be January 14, 2014.[66]

(iii) CFTC Substituted Compliance Regime

The Guidance provides that non-U.S. persons transacting with non-U.S. "branches" of U.S. swap dealers 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) if the CFTC makes 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."[67] A collective investment vehicle that is a non-U.S. person transacting with a non-U.S. branch of a U.S. person swap dealer would benefit from this substituted compliance regime.

In addition, the Exemptive Order provided a temporary delay for non-U.S. branches of U.S. swap dealers in six specified jurisdictions from complying with the CFTC's Transaction-Level Requirements in anticipation of the CFTC making a "substituted compliance" determination with respect to those jurisdictions (which has yet to occur).[68] Instead, the non-U.S. branch of a U.S. swap dealer may comply with applicable foreign law in lieu of complying with the CFTC's Transaction-Level Requirements until the earlier of (i) December 21, 2013 or (ii) 30 days after the CFTC makes a substituted compliance determination.[69] However, this does not apply to compliance with the mandatory clearing requirements for applicable swaps (as noted above, currently only certain CDS and IRS), effective for all swap participants starting on October 9, 2013.

(iv) EMIR No-Action Relief

Additionally, on July 11, 2013, the CFTC issued no-action relief to swap dealers and major swap participants organized in the United States or European Union ("EU") 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.[70] This no-action relief applies solely to (i) uncleared swaps and (ii) physically-settled foreign exchange

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65 CFTC Staff Advisory No. 13-69 (pub. avail. Nov. 14, 2013).

66 CFTC No-Action Letter No. 13-71 (Nov. 26, 2013).

67 Guidance, at 45342.

68 Australia, Canada, the European Union, Hong Kong, Japan, and Switzerland. *Exemptive Order*, at 43788. At this time, certain other significant financial services jurisdictions are not included, such as Singapore, South Korea, and Taiwan (among others).

69 *Exemptive Order*, at 43789.

70 CFTC No-Action Letter No. 13-45 (Jul. 11, 2013).

forward and swap agreements exempted from the definition of swap by the U.S. Department of the Treasury.[71]

(v) Guidance Regarding Collective Investment Vehicles

The Guidance specifically considers the "principal place of business" of collective investment vehicles for determining U.S. person status. The CFTC clarified that the primary focus for identifying the principal place of business with respect to 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."[72] The CFTC will focus primarily on where senior personnel are located.[73] The CFTC will 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.[74]

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."[75] 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.

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."[76] This should 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 Guidance also provides that a collective investment vehicle organized outside the United States 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.

However, even if a collective investment vehicle is not a U.S. person under prong (iii) above, it may still be a U.S. person under prong (vi) if is it majority-owned by U.S. persons.

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71 *Id.* at 3.

72 Guidance, at 45309.

73 Guidance, at 45310.

74 *Id.*

75 *Id.*

76 Guidance, at 45311 n. 207.

(vi) Impact on Collective Investment Vehicles

The Guidance addresses the CFTC's extraterritorial jurisdictional issues for compliance with swap clearing, reporting, and other aspects of Dodd-Frank. It does not impact the analysis of whether a CPO or CTA may be subject to CFTC jurisdiction.

Under the Guidance, a collective investment vehicle that is deemed to be a U.S. person will be subject to Transaction-Level Requirements.

U.S. person CFTC-registered swap dealers and major swap participants, non-U.S. person CFTC-registered swap dealers and major swap participants, and certain other non-U.S. persons are subject to the CFTC's Entity-Level requirements.

A sub-set of the Entity-Level Requirements and Transaction-Level Requirements would apply to transactions between a U.S. person fund and a non-U.S. person non-registrant, including large trader reporting, SDR reporting, clearing, trade execution, real-time public reporting, and swap data recordkeeping requirements. Where a collective investment vehicle that is a U.S. person enters into a swap with a non-U.S. person, obligations that would generally fall to the swap dealer (*i.e.*, SDR reporting and recordkeeping) could instead become the responsibility of the U.S. person vehicle. SDR reporting particularly will be burdensome for vehicles since many non-U.S. swap dealers have not established reporting mechanisms or agreements and are subject to later dates for compliance with the swap dealer registration and compliance requirements (including reporting).

Where a collective investment vehicle is a non-U.S. person but is trading swaps with a swap dealer determined to be a U.S. person, the vehicle 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 swap dealer.

(b) SEC Proposed Cross-Border Guidance and U.S. Person Definition

In May 2013, the SEC proposed its own rules and interpretive guidance to explain the application of the provisions of the Exchange Act that were added by Dodd-Frank to cross-border security-based swap activities ("Proposed SEC Guidance").[77] The Proposed SEC Guidance also sets forth when SBSDs, MSBSPs, and other entities such as clearing agencies, execution facilities, and data repositories must register with the SEC. Comments received from the public on the Proposed SEC Guidance are currently being considered by the SEC.

Under the Proposed SEC Guidance, the SEC would apply its security-based swap rules to security-based swap activities involving (i) a U.S. person or (ii) a transaction conducted within the United States. The SEC's proposed definition of "U.S. person" under proposed Rule 3a71-3 under the Exchange Act includes:

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

[77] *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants*, 78 Fed. Reg. 30968 (proposed May 23, 2013).

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

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

The definition of U.S. person expressly does not include the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies and pension plans, and any other similar international organizations and their agencies and pension plans.

A "transaction conducted within the United States" is defined under proposed Rule 3a71-3 as a security-based swap transaction that is "solicited, negotiated, executed, or booked within the United States, by or on behalf of either counterparty to the transaction, regardless of the location, domicile, or residence status of either counterparty to the transaction."

The Proposed SEC Guidance also includes a process that the SEC proposes to use in considering substituted compliance requests, which this paper will not describe in detail because it has not yet been finalized.

(c) EMIR and Cross-Border Guidance

The EU also has adopted a regulation on derivatives, central counterparties, and trade repositories, titled the European Market Infrastructure Regulation ("EMIR"). In practice, all derivatives (whether transacted in or outside the EU) are within the scope of EMIR, other than (i) physically settled spot FX transactions, and (ii) physically settled commodity derivatives which are entered into for commercial purposes.

Under EMIR, the European Commission (on the advice of the European Securities and Markets Authority ("ESMA")) will determine that a third country's arrangements are "equivalent" to EMIR's requirements. This will allow the party to be deemed to comply with the EMIR clearing, reporting, and risk mitigation obligations by virtue of at least one counterparty complying with the equivalent arrangements in the third country. ESMA has conducted equivalence studies in the United States, Japan, Hong Kong, Switzerland, Canada, and Australia. With respect to certain significant U.S. requirements, the European Commission found as follows:

Clearing. The CFTC and the European Commission have essentially identical processes to designate mandatory clearing obligations. The same products are likely to be subject to clearing in the United States and the EU. In terms of which market participants are covered, regulators have agreed to a "stricter rule applies" approach where exemptions from clearing exist in one jurisdiction but not the other. As a result, where an entity is subject to both U.S. and EU rules on clearing, it may disapply the EU obligation if the product is subject to clearing in the United States and the EU.

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

(i) Timely confirmation – equivalent, but reporting of unconfirmed trades to the EU regulator is not disapplied.

(ii) Portfolio reconciliation – equivalent.

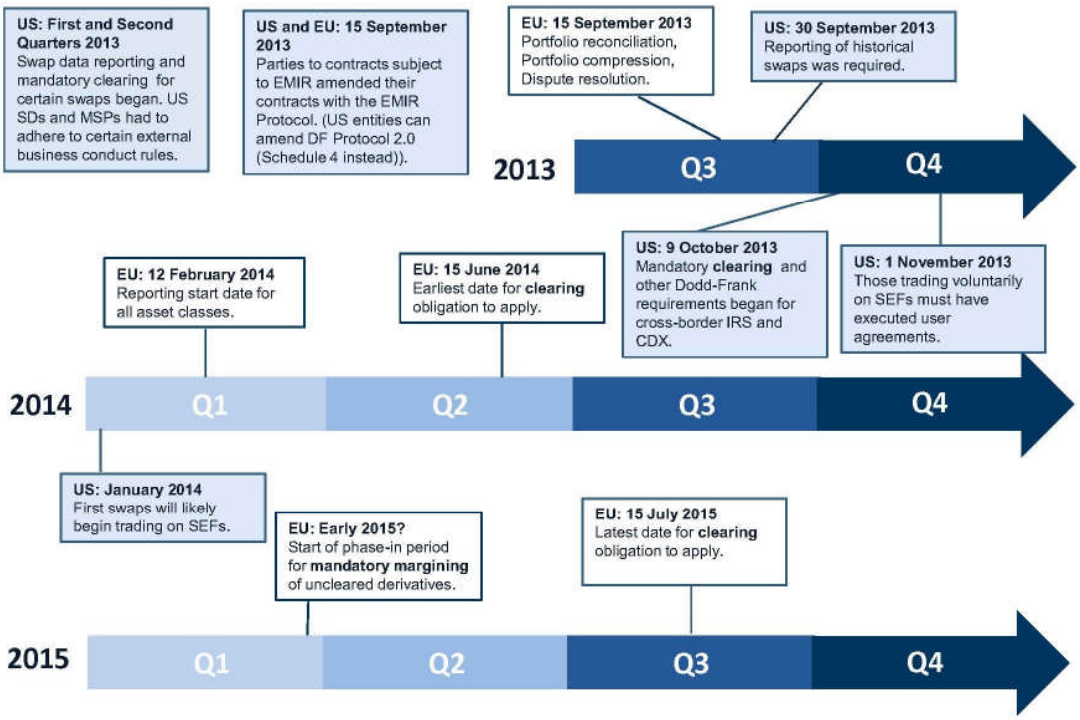
(iii) Portfolio compression – equivalent.

(iv) Dispute resolution – not equivalent.

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

(vi) Reporting – not equivalent. CFTC data fields do not encompass all of EMIR's data fields, such as exposure.

As a result of the above, U.S. person funds may be subject to both Dodd-Frank and EMIR requirements. The following chart sets forth the implementation deadlines for EMIR provisions.



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.[78] 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.[79]

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 FCM or a DCO.[80] 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.

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78 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 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.

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

80 CFTC Regulations Part 22.

- 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.[81] 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 U.S. Bankruptcy Code, meaning that the customer posting margin via a third-party account may remain subject to the risk mutualization concerns discussed above.

Section 17(f) of the U.S. Investment Company Act of 1940 as amended ("1940 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.[82] Rule 17f-6 under the 1940 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 pursuant to certain requirements. Through a series of 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.[83]

(ii) Uncleared Swap Accounts – Election of Segregation

Swap dealers and major swap participants must notify their uncleared swaps counterparty that the counterparty may elect segregation of its initial margin in an account maintained by a custodian independent of both the counterparty and the swap dealer or major swap participant.[84] Swap dealers and major swap participants must comply with this rule by May 5, 2014 for uncleared swap

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81 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).

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

83 *See, e.g.,* Chicago Mercantile Exchange (Credit Default Swaps) (pub. avail. Sept. 27, 2012); Chicago Mercantile Exchange (Interest Rate Swaps) (pub. avail. Sept. 27, 2012); ICE Clear Credit LLC (pub. avail. Sept. 27, 2012); LCH Clearnet Limited (pub. avail. Sept. 27, 2012); Chicago Mercantile Exchange (Cash-Settled Commodity Index Swaps and Foreign Currency Swap Contracts) (pub. avail. July 10, 2013).

84 CFTC Regulation 23.701-02.

transactions with new counterparties or by November 3, 2014 for swap transactions with existing counterparties.

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

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.[85] 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.[86] The amount maintained must be at least equal to customers' aggregate undermargined amounts for the prior trade date (as discussed herein).[87] 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 will be phased in over a five year period. The CFTC will study the rule over the next 30 months and may change the deadline for posting the required collateral during this time.

- During the first year – no changes will occur.
- 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.
- 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.[88] 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."

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85 CFTC Regulation 1.20.

86 *Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations*, 78 Fed. Reg. 68506 (Nov. 14, 2013).

87 CFTC Regulations 1.20(a) and 1.22.

88 CFTC Regulations Part 22.

Uncleared Swaps: Under new rules adopted in October 2013, once effective, margin that swaps counterparties have elected to be segregated may only be invested in accordance with CFTC Regulation 1.25.[89]

(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.[90]
- New risk management programs and organizational requirements.[91]
- Enhanced reporting, recordkeeping, and disclosure rules.[92]
- New rules for self-regulatory organizations and certified public accountants.[93]
- Updates to FCM bankruptcy rules.[94]

VI. BLOCK TRADES

Dodd-Frank and CFTC regulations require the real-time reporting of swap transaction and pricing data.[95] 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."[96] 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.[97] If 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

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89 CFTC Regulation 23.703.

90 CFTC Regulation 1.23(d).

91 CFTC Regulations 1.11 and 1.16.

92 CFTC Regulations 1.12 and 1.55.

93 CFTC Regulation 1.52.

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

95 CEA Section 2(a)(13).

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

97 Procedures To Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 78 Fed. Reg. 32866, 32870 (May 31, 2013) ("Block Trade Adopting Release").

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. 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.[98] A general grant of investment management discretion is not adequate.[99]

(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;[100]

(ii) the investment adviser has more than $25 million in assets under management;[101] and

(iii) the investment adviser is:

(A) a registered or exempt CTA which has discretionary trading authority or directs client accounts,[102]

(B) a registered investment adviser ("RIA") which has discretionary trading authority,[103] or

(C) a foreign equivalent to a CTA or RIA.[104]

In addition, the aggregated orders must be executed as a single swap order and may not be aggregated after they have been executed.[105] Furthermore, while CFTC regulations do not expressly require client consent for aggregating positions with other clients in order to reach the

98 CFTC Regulation 43.6(i)(2).

99 Block Trade Adopting Release, at 32906.

100 CFTC Regulation 43.6(h)(6).

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

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

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

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

105 CFTC No-Action Letter No. 13-48 (Aug. 6, 2013), at 3.

minimum block trade size, the adopting release to those regulations suggests that such consent must be obtained.[106]

VII. POSITION LIMITS

Dodd-Frank amended the CEA to direct the CFTC to establish position limits for futures and options contracts traded on a DCM as well as swaps and other contracts that are economically equivalent to such contracts.[107] On November 18, 2011, the CFTC published a comprehensive set of regulations on speculative position limits on exchange-traded futures and options contracts and economically-equivalent OTC derivatives referencing 28 individual agricultural, metal, and energy commodities.[108] The regulations also required market participants to aggregate position limits across accounts and positions they control, subject to certain exceptions. On May 30, 2012, the CFTC published proposed modifications to its policy for aggregation under the CFTC's new position limits regime.[109] On September 28, 2012, the CFTC's position limit regulations were vacated by the U.S. District Court for the District of Columbia and remanded to the CFTC.[110]

On November 5, 2013, the CFTC proposed a new set of position limit regulations and aggregation standards.[111] The new proposal largely mirrors the vacated final regulations, but differs in a number of respects. For example, the new proposal narrows the exemption from position limits for *bona fide* hedging by eliminating exemptions for anticipatory hedging and adds a significant exemption to the spot month limit for cash-settled contracts where the trader does not hold any physically-delivered contracts in the same commodity. The proposal also expands upon the circumstances under which aggregation is not required.

(a) Setting Position Limits

The calculations of position limits in the proposed regulations are substantially similar to the vacated ones, and position limits will be set with the following procedure:

- Spot-month position limits will generally be set at 25% of estimated deliverable supply, with initial limits set at levels currently in place at DCMs. Spot month limits will be applied separately for physical-delivery and cash-settled contracts, and traders cannot net positions across the two categories of contracts.

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106 Block Trade Adopting Release, at 32906.

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

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

109 *Aggregation, Position Limits for Futures and Swaps*, 77 Fed. Reg. 31767 (May 30, 2012).

110 *Int'l Swaps and Derivatives Association v. U.S. Commodity Futures Trading Comm'n*, 887 F. Supp. 2d 259 (D.D.C. 2012).

111 *Position Limits for Derivatives*, Commodity Futures Trading Comm'n (Nov. 5, 2013), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister110513c.pdf (to be codified at 17 C.F.R. pts. 1, 15, 17, 19, 32, 38, 140, 150); *Aggregation of Positions*, 78 Fed. Reg. 68946 (proposed Nov. 15, 2013) (to be codified at 17 C.F.R. pt. 150).

- Non-spot month contracts (*i.e.*, single month and all-months-combined) position limits will be set using a "10/2.5 percent formula": 10% of the contract's first 25,000 of open interest and 2.5 percent of further open interest. The proposed regulations permit netting across physical-delivery and cash-settled contracts for non-spot month limits.

The proposed regulations permit traders to hold cash-settled spot-month positions in any referenced commodity at a level five times greater than the spot-month limit, but only if the trader does not hold *any* physical-delivery spot-month contracts in the same referenced commodity. The vacated regulations, by contrast, established the same limits for cash-settled and physical-delivery contracts except that they permitted traders in certain natural gas contracts to hold cash-settled spot-month positions at a level five times greater than the spot-month limit, subject to certain conditions.

(b) Exemptions to Position Limits

As with the prior vacated regulations, positions in futures, options, and swaps entered into in good faith prior to the effective date that exceed position limits are proposed to not be considered in violation of the regulations. Diversified commodity index contracts are expressly excluded from the scope of these regulations.

The *bona fide* hedging exemption under current CFTC regulations is narrowed under the proposed regulations. Specifically, the proposed regulations remove some exemptions for certain types of anticipatory hedging and limit the *bona fide* hedging exemption to specific hedges. Additionally, the proposed regulations eliminate the existing process for seeking a non-enumerated exemption for *bona fide* hedging. While the CFTC retains its exemptive authority under the CEA, the proposed regulations do not prescribe a specific process under which an affected trader may seek a non-enumerated exemption.

(c) Aggregation of Positions

The proposed aggregation regulations reference the existing aggregation scheme contained in Part 150 of CFTC Regulations and are substantially similar to the proposed May 2012 amendments to the vacated regulations. The proposed aggregation regulations expand the available exceptions to aggregation by creating four new contexts 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 of 50% or less in another entity, but such other entity's trading is independently controlled (subject to a notice filing).

3. Where the market participant has an ownership interest of greater than 50% in another entity, but the CFTC finds in its discretion (among other things) that the other entity is not consolidated with the applicant under U.S. generally accepted accounting principles, the other entity's trading is independently controlled, 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% of any applicable position limit, and complies with certain other conditions.

4. Where the market participant has an ownership in another entity solely as the result of 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.[112] The IAC concept is a long-permitted exemption from aggregation under the CFTC's position limit regulations. Under the IAC exemption, certain eligible persons (including registered or excluded CPOs or CTAs to registered investment companies and other types of funds)[113] 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 and other conditions are satisfied. Among other things, the proposed changes to the IAC definition extend the IAC concept beyond the proposed 2012 amendments 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 regime as well as the proposed regime.

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[112] CFTC Regulation 150.1(e).

[113] CFTC Regulation 150.1(d).

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