

## CFTC Affords Relief and Guidance in Light of Final Swap Definition's Effective Date

October 19, 2012

On October 12, 2012, the Commodity Futures Trading Commission's (CFTC) and Securities and Exchange Commission's (SEC) [final rules](#) to further define the term "swap" (among other terms) became effective. The effective date of the final rules [triggered the compliance dates](#) for a large number of CFTC requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Recognizing that many market participants are facing uncertainty in how the new rules apply and are currently unable to comply with the new requirements, pending finalized rules, relief or guidance from the CFTC, the CFTC issued a series of no-action relief letters and other guidance late last week. This Legal Alert describes the relief and guidance that the CFTC has issued to date. Additional guidance is expected to be issued in the coming weeks. To access a particular section of interest, please click on the relevant link below.

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### 1. Registration of Swap Dealers, Major Swap Participants and Other Intermediaries

#### a. Determining Swap Dealer or Major Swap Participant Status

Market participants are required to account for all swap transactions entered into after October 12, 2012 in determining whether they are swap dealers or major swap participants. Relief was granted to account for certain pending regulatory actions and to provide certain market participants additional time to transition their current business practices to the new regulatory environment. The CFTC's Division of

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Swap Dealer and Intermediary Oversight (DSIO) afforded market participants the following guidance and temporary relief with regard to swap dealer and major swap participant status.

*i. FAQs – Swap Dealer and Major Swap Participant Calculations*

The DSIO published a series of [questions-and-answers](#) (FAQs) related to the determination of swap dealer and major swap participant status under the CFTC's [final rules](#) further defining the terms "swap dealer" and "major swap participant." For the swap dealer definition, the FAQs provide guidance on a variety of issues including with respect to identifying swap dealing activity, calculating notional amounts, and aggregating swap dealing positions among affiliates. For the major swap participant definition, the FAQs provide guidance with respect to, among other things, the regulatory safe harbors from major swap participant status, calculation of notional amounts, and the treatment of guarantees.

*ii. Cross-Border Relief*

One of the most controversial aspects of derivatives reform under the Dodd-Frank Act is the extent to which the law's new requirements will apply to persons located outside of the United States. The CFTC's [proposed guidance](#) on this topic that was issued earlier this year, which was met with widespread criticism from market participants and foreign regulators, has yet to be finalized. Accordingly, the DSIO issued a [no-action letter](#) indicating that, until the earlier of December 31, 2012, or the effective date of final guidance regarding the cross-border application of the Dodd-Frank Act requirements, non-U.S. persons (as defined in the letter) do not need to include any transactions with other non-U.S. persons when performing the calculations required under the swap dealer and major swap participant definitions. Notably, the letter adopts a definition of U.S. person that is less burdensome than the definition of that term that was contained in the proposed guidance. In addition, the no-action letter addresses the cross-border treatment of swaps between non-U.S. persons and foreign branches of U.S. persons until the earlier of December 31, 2012 or the effective date of final guidance on the cross-border application of the Dodd-Frank Act requirements.

*iii. FX Forwards and Swaps*

Foreign exchange (FX) forwards and FX swaps are "swaps" under the Commodity Exchange Act (CEA) and under the CFTC's regulations. However, under the Dodd-Frank Act, the United States Secretary of the Treasury has the discretion to exclude FX forwards and FX swaps from certain swaps-related regulations. Although the U.S. Treasury [proposed](#) to exclude FX forwards and FX swaps from regulation last year, it has not yet issued a final determination. As a result, FX forwards and FX swaps are currently subject to regulation as swaps.

The U.S. Treasury is expected to issue a final determination as to whether it will exclude FX forwards and FX swaps from regulation by year end. As a result, the DSIO issued a [no-action letter](#) that permits market participants to exclude FX forwards and FX swaps when determining their potential status as a major swap participant or swap dealer until December 31, 2012, assuming that there is no other swap dealing activity. If a person engages in swap dealing activity with respect to FX forwards and FX swaps *and* other types of swaps, it may not exclude FX forwards or FX swaps when determining the aggregate gross notional amount of its swap dealing activity.

The DSIO's no-action letter also indicates that until December 31, 2012, persons that would be commodity pool operators (as discussed below) or commodity trading advisors solely as a result of FX forward or FX swap trading activity are not currently required to register with the CFTC.

iv. *Utility Special Entities*

Subject to certain conditions, [the \*de minimis\* threshold for swap dealing activity in “utility commodity swaps” with “Utility Special Entities”<sup>1</sup> has been temporarily increased from \\$25 million to \\$800 million.](#) “Utility Special Entities” are those that: (1) own or operate electric or natural gas facilities or electric or natural gas operations (or anticipated facilities or operations); (2) supply natural gas and/or electric energy to other Utility Special Entities; (3) have public service obligations (or anticipated public service obligations) under Federal, State or local law or regulation to deliver electric energy and/or natural gas service to utility customers; or (4) are Federal power marketing agencies as defined in Section 3 of the Federal Power Act.

The increase in the *de minimis* threshold to \$800 million will remain in effect until the effective date of any CFTC action with respect to the [petition](#) upon which this relief is based that was submitted to the CFTC last July by the American Public Power Association, the Large Public Power Council, the American Public Gas Association, the Transmission Access Policy Study Group and the Bonneville Power Administration.

v. *Swaps in Agricultural and Exempt Commodities*

The DSIO issued a [no-action letter](#) regarding the treatment of agricultural and exempt commodity swaps in making calculations for purposes of the swap dealer and major swap participant definitions. Pursuant to this letter, any swaps referencing an exempt commodity or agricultural commodity that are executed between October 12, 2012, and October 20, 2012, do not need to be included in the calculation of: (1) aggregate gross notional amount of swaps connected with swap dealing activity for purposes of the swap dealer definition, or (2) daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure for purposes of the major swap participant definition.

vi. *Cleared Agricultural and Exempt Commodity Swaps and Swaps Exchanged for Futures*

The DSIO issued another [no-action letter](#) regarding the swap dealer and major swap participant definitions. This no-action letter covers the treatment of agricultural and exempt commodity swaps that are: (1) cleared on a derivatives clearing organization that is registered with the CFTC; or (2) entered into contingent on being subsequently exchanged for and cleared as futures positions, as part of exchange for related position transactions conducted in accordance with a regulated exchange’s rules. Pursuant to the letter, swaps that are executed between October 12, 2012, and December 31, 2012, do not need to be included in the calculation of: (1) aggregate gross notional amount of swaps connected with swap dealing activity for purposes of the swap dealer definition; or (2) daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure for purposes of the major swap participant definition.

**b. Blanket Relief From Registration for Swaps Intermediaries**

In addition to providing guidance with respect to the swap dealer and major swap participant definitions, the DSIO issued a [no-action letter to provide relief from registration for various swaps intermediaries until December 31, 2012](#). This relief applies to any person who, solely by virtue of his or her swaps activity, would have been required to register immediately as an introducing broker, commodity pool operator,

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<sup>1</sup> Special Entities are: (1) Federal agencies; (2) State agencies, cities, counties, municipalities or other State political subdivisions; (3) employee benefit plans and governmental plans under the Employee Retirement Income Security Act of 1974; and (4) endowments. See Section 4s(h)(2)(C) of the Commodity Exchange Act (CEA).

commodity trading advisor, associated person, floor broker, or floor trader on October 12, 2012. In addition, the no-action letter provides relief for any person who would have been required to register with the CFTC solely because of his or her involvement with the transition of certain contracts from swaps to commodity futures and options on the IntercontinentalExchange (ICE) and the New York Mercantile Exchange (NYMEX).

Affected swaps intermediaries are required to file applications for registration with the National Futures Association (NFA), the self-regulatory organization to which the CFTC has delegated the registration of intermediaries, by December 31, 2012. In the interim, the no-action letter requires the affected swaps intermediaries to make good-faith efforts to comply with the requirements under the CEA and CFTC regulations that would apply to them if they were registered.

The no-action letter also permits swap dealers and major swap participants to employ associated persons, notwithstanding that such persons are subject to a statutory disqualification, on the condition that such swap dealers and major swap participants consult with the NFA prior to doing so. This relief does not have a termination date but is subject to certain conditions.

## 2. Blanket Relief for Regional Transmission Organizations, Independent System Operators and Electric Cooperatives in Light of Pending Petitions and Proposals

The DSIO, the CFTC's Division of Market Oversight and the CFTC's Division of Clearing and Risk jointly issued two no-action letters in response to requests for relief from market participants that resulted in proposed exemptive relief orders that have yet to be finalized. Both no-action letters afford the relevant market participants the relief that would be available to them if the proposed orders are finalized without modification. Such relief will remain in effect until the CFTC takes final action with respect to the relevant proposed order.

The [first jointly-issued no-action letter](#) affords relief with respect to contracts, agreements and transactions for the purchase or sale of certain limited electricity-related products from certain Dodd-Frank Act requirements. The [proposed order](#) upon which the no-action letter is based was issued in response to a joint petition for no-action relief from the California Independent Service Operator Corporation, the Electric Reliability Council of Texas, Inc., ISO New England Inc., Midwest Independent Transmission System Operator, Inc., New York Independent System Operator, Inc., and PJM Interconnection, L.L.C.

The [second jointly-issued no-action letter](#) affords no-action relief from certain Dodd-Frank Act requirements with respect to "electric energy-related transactions" between not-for-profit electric utilities. "Electric energy-related transactions" are those agreements, contracts or transactions whose primary purpose is to satisfy existing or anticipated contractual obligations to facilitate the generation, transmission, and/or delivery of electric energy service to customers at the lowest cost possible; intent to make/take physical delivery is required. The [proposed order](#) upon which the no-action letter is based was issued in response to a joint [petition](#) for no-action relief from the National Rural Electric Cooperative Association, the American Public Power Association, the Large Public Power Council, the Transmission Access Policy Study Group, and Bonneville Power Administration.

## 3. Clarification on Eligible Contract Participant Issues

The CFTC's Office of General Counsel (OGC) issued a letter providing [interpretative guidance and no-action relief](#) regarding Eligible Contract Participant (ECP) issues. The letter provides that: (1) swap

guarantors generally must be ECPs; (2) non-ECPs generally may not be jointly and severally liable for swap obligations; and (3) cash proceeds from a loan may be included within the calculation of total assets for purposes of qualifying as an ECP under the CEA. The letter also provides no-action relief, subject to specified conditions, with respect to certain ECP guarantee arrangements, “anticipatory ECPs,” and certain determinations regarding “amounts invested on a discretionary basis.”

#### 4. Commodity Pool Operator Status

Under the CEA and CFTC regulations promulgated thereunder, commodity pools are defined as investment vehicles that are “operated for the purpose of trading commodity interests.” By filing an application with the NFA, Commodity Pool Operators (CPOs) are required to register with the CFTC and are subject to a number of compliance obligations including, among others, disclosure document requirements, delivery of disclosure to commodity pool participants, recordkeeping and periodic reporting.

Prior to the Dodd-Frank Act, the term “commodity pool” was defined only in the CFTC’s regulations. Moreover, the term did not include swaps in the universe of derivatives that could cause an investment vehicle to be a commodity pool. The Dodd-Frank Act significantly expanded the CEA’s reach by: (1) adding a statutory definition of “commodity pool” to the CEA that includes swaps within the list of derivatives that can cause an investment vehicle to be a commodity pool; and (2) making a conforming change to the statutory CPO definition. As a result, funds that invest in swaps, irrespective of the purpose for which they invest in swaps and the amount of their swaps investments, are technically commodity pools. Therefore, the managers of such funds are technically CPOs. Absent being eligible for a statutory or regulatory exclusion or exemption, such CPOs must register with the CFTC and satisfy the aforementioned compliance obligations.

In response to requests for no-action relief, the DSIO issued, subject to certain conditions [interpretative guidance](#) indicating that certain real estate investment trusts (REITs) that hold income-producing real estate and that engage in real estate management activities (including leasing and maintaining real estate, providing a variety of tenant services, and developing and redeveloping real estate) (i.e., equity REITs) are not commodity pools. The DSIO similarly issued [no-action relief](#) to operators of certain funds that issue asset-backed securities (including mortgage-backed securities) (i.e., securitization vehicles). Although the DSIO declined to afford relief to CLOs, CDOs or covered bonds, it invited securitization vehicles that were not covered to apply for separate relief.

In addition to the two no-action letters providing that certain entities are not commodity pools, the DSIO issued [guidance](#) with respect to the use of the phrase “bona fide hedging” in [CFTC Regulation 4.5](#), which excludes advisers of registered investment companies from the CPO definition. CFTC Regulation 4.5 was [recently amended](#) to condition the exclusion from CPO status on the requirement that a registered investment company seeking to qualify for the exclusion must ensure that its non-bona fide hedging commodity interest trading falling below certain specified thresholds. Pursuant to the DSIO’s guidance, the phrase “bona fide hedging” in CFTC Regulation 4.5 is within the meaning and intent of that phrase in the CFTC’s [final position limits rules](#), despite the fact that such rules were [vacated by the U.S. District Court for the District of Columbia](#) last month.

#### 5. Guidance With Respect to Swap Data Reporting Requirements

##### a. Reporting of Cleared Swaps

The CFTC responded to FAQs from market participants and other interested parties on the reporting of cleared swaps as required under [Part 45](#) of the Commission’s regulations. The CFTC’s [FAQs](#) are



intended to help market participants better understand how to report cleared swaps, who has the obligation to report, and the timing for reporting.

#### b. General Swap Data Reporting Requirements

The CFTC issued a response to frequently asked questions ([FAQs](#)) to help market participants and other interested parties better understand the new rules regarding: (1) the timing of when counterparties will be required to report swap pricing and transaction data; (2) the reporting that is required; and (3) who has the obligation to report. In particular, the FAQs address the impact of swap dealer or major swap participant registration on the swap data reporting requirements.

### 6. Segregation of Cleared Swaps Customers' Collateral

Earlier this year, the CFTC adopted [final rules](#) to implement a "legal segregation with operational commingling" model for the segregation of cleared swaps customer collateral (the LSOC Model) held by futures commission merchants (FCMs) and derivatives clearing organizations (DCOs). The final rules are intended to implement the statutory segregation of customer collateral requirements of the CEA. Pursuant to the CFTC's final rules, FCMs and DCOs will be required to comply with the LSOC Model beginning on November 8, 2012.

Market participants sought clarification from the CFTC as to whether compliance with the LSOC Model would be required as of the swap definition's effective date. They were concerned about timing for compliance since, pursuant to the [CFTC's order pertaining to the effective date of swaps regulation](#), compliance with the customer collateral segregation provisions of the CEA was technically required as of October 12, 2012. In response, the CFTC's Division of Clearing and Risk issued a [no-action letter](#) clarifying that compliance with the LSOC Model will not be required until November 8.



*If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

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