

# Client Alert

Latham & Watkins Corporate Department

## CFTC Issues a Flurry of No-Action Letters and Guidance as New Swap Regulations Become Effective

In its adopting release for its final rulemaking further defining the term "swap" (the Swap Definition Rules),<sup>1</sup> the US Commodity Futures Trading Commission (CFTC) designated an effective date for the Swap Definition Rules of Friday, October 12, 2012 (the Regulatory Cliff Friday).<sup>2</sup> The designation of this effective date was significant because the compliance dates for many other rules promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) were dependent (and automatically occurred) on the effective date of the Swap Definition Rules. As the October 12, 2012 deadline neared, however, it became clear that there existed a great deal of uncertainty in the market regarding the practical application of the CFTC's various new rulemakings. Between October 10 and October 12, the CFTC issued a series of no-action and interpretive letters and other guidance regarding rules issued under Dodd-Frank. The no-action letters and guidance address a broad range of topics, which include the following categories:

- Swap entity definitions
- Extraterritoriality
- Foreign exchange
- Agricultural and exempt commodities
- Commodity pool regulations
- Introducing brokers, commodity pool operators, commodity trading advisors, floor brokers and floor traders
- Energy-related transactions
- Swap data reporting
- Eligible contract participants

This *Alert* offers only a brief summary of these letters and guidance documents. Please feel free to contact any of the authors identified below for further clarification.

### Swap Entity Definition Guidance

#### Guidance Regarding Swap Dealers and Major Swap Participants

In response to questions regarding the regulations covering "swap dealers" and "major swap participants" (the Final Entity Rules), the CFTC's Division of Swap

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Dealer and Intermediary Oversight (DSIO) issued a series of interpretations on the application of the Final Entity Rules. The guidance addresses seven discrete topics: (i) calculating the notional amount of swap positions; (ii) aggregation of the swap positions of affiliates; (iii) identifying swap dealing activity; (iv) the insured depository loan exception; (v) special entities (*i.e.*, federal agencies or other government entities, municipalities, ERISA plans and endowments); (vi) calculating the notional amount of options and swaptions; and (vii) major swap participant safe harbors. The guidance clarifies certain issues pertaining to these topics, such as, for example, when calculating the notional amount of a physical commodity swap, the value of the physical underlying is the fair market value of the physical underlying at the time of the execution of the swap; insured depository institutions are eligible for the *de minimis* exception; the notional value of a swaption looks through the option contract to the underlying swap for purposes of determining the notional amount; and entities should begin to calculate their daily average exposures for purposes of the major swap participant definition on October 12, 2012, and if an entity meets the criteria during the 4th quarter of 2012, that entity must register within 2 months after the end of that quarter (*i.e.*, the end of February 2013).

### **Extraterritoriality No-Action Relief**

Because the CFTC's extraterritorial interpretive guidance is not yet final, DSIO has offered limited no-action relief in order to enable swap market participants outside the US to apply a uniform, ascertainable standard regarding which swaps — as of October 12, 2012 — must be included when assessing swap dealer and major swap participant status.<sup>4</sup> Essentially, DSIO established a short-form test for US person status. Under the limited no action relief, DSIO will not recommend any enforcement action against any person that itself is not a US person under this short-form test for failure to include a swap executed prior to December 31, 2012 in its swap dealer and major swap participant analysis *so long as the counterparty is not*: (i) a natural person who is a resident of the United States; (ii) a 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, in each case that is organized or incorporated under the laws of the United States; (iii) a pension plan for the employees, officers or principals of a legal entity described above, unless the pension plan is exclusively for foreign employees of such entity; (iv) an estate or trust, the income of which is subject to US income tax regardless of source or (v) an individual account (discretionary or not) where the beneficial owner is a person described above.

Consistent with the CFTC's proposed extraterritorial interpretive guidance, the no-action relief provided by the CFTC applies where the counterparty to the swap is not a US person under the short-form test (*i.e.*, does not fall into clauses (i) through (v) above), regardless of whether the counterparty's obligations under the swap are guaranteed by a US person. Finally, DSIO confirmed that it would not recommend that the CFTC take enforcement against any person that is not a US person under the short-form test above for failing to include swaps executed prior to December 31, 2012, or the effective date of a final exemptive order regarding extraterritoriality, in its swap dealer or major swap participant assessment if the counterparty is a foreign branch of a person described in clauses (i) through (v) above and such person represents that it intends to register with the CFTC as a swap dealer by March 31, 2013.

### **FX Swaps and FX Forwards Temporary No-Action Relief**

The Treasury Secretary has authority under Dodd-Frank to exempt FX swaps and forwards from the definition of “swap,” but did not finalize its proposal to do so by October 12, 2012. The CFTC has stated that if Treasury finalizes its determination by December 31, 2012, entities will not have to count FX swaps and forwards toward their *de minimis* dealing exception or their MSP calculation. These entities, however, may not know whether they have to count these transactions until very close to the time they must register.

### **Agricultural and Exempt Commodities Transitional No-Action Relief**

According to the CFTC, over the past several weeks, several major trading platforms that have been providing over-the-counter (OTC) markets for cleared swaps in exempt commodities, such as energy commodities and metals, have announced their intention to transition the cleared swap activities offered on those markets to cleared futures contracts.<sup>6</sup> To enable any such transition to proceed in an orderly manner, DSIO stated that it will not recommend that the CFTC take enforcement action against any person for failure to include, in its calculation of the aggregate gross notional amount of swaps connected with its swap dealing activity, a swap that: (i) references an exempt commodity or agricultural commodity, (ii) is executed prior to December 31, 2012, and (iii) is either cleared on a registered derivatives clearing organization (DCO) or entered into contingent upon its being subsequently exchanged for and cleared as a futures position as part of an exchange for related position transaction conducted in accordance with a DCM's rules.

### **Utility Special Entities Temporary No-Action Relief**

The Final Entity Rules provide that the *de minimis* threshold for swap dealer registration for entities trading with “special entities” is \$25 million. On July 12, 2012, the CFTC received a petition requesting that the CFTC regulations be amended to exclude from the special entity *de minimis* threshold swaps that relate specifically to utility operations. DSIO is still considering the petition and the public comments submitted with regard to the petition. In the meantime, therefore, DSIO believes that no-action relief with regard to the special entity *de minimis* threshold is appropriate for utility special entities.<sup>7</sup>

### **Eligible Contract Participant (ECP) Guidance**

In response to various requests for further clarification regarding the scope of the ECP definition, the CFTC's Office of General Counsel (OGC) provided the following additional interpretations: (i) each guarantor of a swap must also be an ECP unless certain conditions are satisfied; (ii) a non-ECP cannot be a jointly and severally liable with an ECP for a swap and (iii) while assets purchased or a project constructed with loan proceeds count towards the \$10 million in the total assets threshold of CEA section 1a(18)(A)(v)(I), so too do the cash proceeds of the loan, upon receipt by the borrower. <sup>8</sup>

Additionally, OGC granted no-action relief to address three specific requests for relief relating to: (a) additional persons that would qualify as an eligible guarantor able to confer ECP status on certain non-ECPs; (b) “anticipatory ECPs,” where, for example, a lender has provided a borrower a commitment to fund a loan amount greater than \$10 million, and therefore the borrower would qualify as ECPs under the asset test, except that the loan is funded incrementally as a project progresses and (c) an interpretation of the provision in the CEA that was amended to refer to an ECP with regard to its “assets invested on a discretionary basis.”

## Commodity Pool Guidance

### Commodity Pool Exclusions

Dodd-Frank amended the CEA to add swaps to the list of “commodity interests” in the definition of “commodity pool.”<sup>9</sup> As a consequence, many pooled investment vehicles that enter into swaps will be deemed to hold “commodity interests” and could be regulated as commodity pools by the CFTC. Most significantly, persons who perform day-to-day, administrative functions with respect to such pooled vehicles could be required to register as commodity pool operators (CPOs). Notwithstanding the expanded definition of “commodity pool,” DSIO determined that certain pooled vehicles should not be included within the definition of “commodity pool” and their operators should not be included within the definition of “commodity pool operator.” Specifically, DSIO will exclude securitization vehicles and their operators from the definition of “commodity pool” and “commodity pool operator” (CPO) if they are operated in accordance with Rule 3a-7 under the Investment Company Act or the SEC’s Regulation AB, and meet other conditions related to the passivity of the pool.<sup>10</sup> DSIO will also exclude real estate investment trusts from the definition of “commodity pool” when certain conditions are satisfied.<sup>11</sup> These letters follow an interpretive letter from DSIO on October 5, 2012 finding that a limited liability company whose members were all family members was not a commodity pool and, as a result, the managing member was not a required to register as a CPO.<sup>12</sup> DSIO also published an FAQ document on August 14, 2012 that attempted to clarify several grey areas in connection with CPO and CTA regulation.<sup>13</sup> Despite this guidance, many questions still remain and many entities that were not previously CPOs will be required to register or file for an exemption.

### Bona Fide Hedging Rule under CFTC 4.5

On February 24, 2012, the CFTC amended its regulation 4.5 concerning CPOs and Commodity Trading Advisors (CTAs) to include a commodity interest trading threshold above which the operator of a registered investment company (*e.g.*, a mutual fund) would be included within the definition of “commodity pool operator.”<sup>14</sup> The amended regulations excluded from the calculation of these thresholds, however, any positions that would qualify as “bona fide hedging” within the “meaning and intent” of CFTC regulations 1.3(z)(1) and 151.5, defining “bona fide hedging” for the separate purpose of exclusion from position limits for futures and swaps. On September 28, 2012, the position limits rule that promulgated CFTC regulation 151.5, and amended CFTC regulation 1.3(z)(1), was vacated by a US District Court. However, because the bona hedging standard was not challenged in the litigation in the context of the definition of a CPO, DSIO reaffirmed the bona fide hedging tests that had been set forth under the position limits for purposes of determining whether the commodity interest trading thresholds in CFTC regulation 4.5 are triggered. It is worth noting that CFTC regulation 4.5 is itself subject to litigation and it remains unclear whether the CFTC’s amendments to regulation 4.5 will withstand judicial scrutiny.

### Registration Deadlines for CPOs, CTAs and Other Regulated Entities

DSIO confirmed that it will not recommend an enforcement action be brought against any of the following regulated entities for failing to register by October 12, 2012, if their registration obligations arise solely because of their activities involving swaps: CPOs, CTAs, introducing brokers, floor brokers, floor traders,

associated persons of any of the foregoing or associated persons of a futures commission merchant (FCM). This no-action relief is only temporarily available, and the regulated entities must make certain filings with the NFA prior to December 31, 2012.

## Proposed Energy-Related Transactions

In August 2012, the CFTC published (and requested comment on) two proposed orders that would exempt certain energy-related transactions from many of the requirements of the CEA. The first proposed order<sup>15</sup> would exempt non-financial energy derivative transactions between government-owned electric utilities and/or cooperatively-owned electric utilities when such transactions are intended to be physically settled and are entered into for the primary purpose of meeting current or anticipated contractual obligations to facilitate the generation, transmission or delivery of electricity. The second proposed order<sup>16</sup> would exempt four types of transactions when they are offered or sold in a market administered by certain Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs) pursuant to a tariff or protocol that has been approved by the Federal Energy Regulatory Commission (FERC) or, as applicable, the Public Utility Commission of Texas (PUCT). The CFTC is still considering comments on the two proposed orders. Therefore, to maintain the status quo, the various divisions of the CFTC responsible for the two proposed orders have agreed not to recommend any enforcement action pertaining to the entities and transactions that would satisfy the conditions set forth in the two proposed orders.<sup>17</sup>

## Swap Data Reporting

### Compliance Dates for Swap Data Reporting

In response to questions regarding the swap reporting obligations pertaining to swap dealers, major swap participants, and non-swap dealers and non-major swap participants (*i.e.*, the Nons), the CFTC issued a Q&A document<sup>18</sup> clarifying the compliance dates for swap data reporting. The following table summarizes the reporting obligations for each type of entity under parts 45 and 46 of the CFTC's regulations:

ENTITY TYPE	ASSET CLASS	COMPLIANCE DATE
Swap Dealer	Credit and interest rates	For SDs passing the <i>de minimis</i> threshold in October 2012, either: (1) on the date after October 12, 2012, but before December 31, 2012, on which the SD's registration application is submitted or (2) on December 31, 2012, if no application is submitted earlier.
		For SDs passing the <i>de minimis</i> threshold after October 2012, either: (1) on the date on which the SD's registration application is submitted or (2) the final day of the second month after the month in which the SD passes the gross notional amount threshold.

ENTITY TYPE	ASSET CLASS	COMPLIANCE DATE
Swap Dealer	Equity, FX, other commodities Swaps	For SDs passing the <i>de minimis</i> threshold in October 2012, on January 10, 2013.
		For SDs passing the <i>de minimis</i> threshold after October 2012, either: (1) on January 10, 2013, if the SD's registration application is submitted prior to or on January 10, 2013, (2) on the date the SD's registration application is submitted, if that date is after January 10, 2013, but before the application is required to be submitted or (3) on the final day of the second month after the month in which the SD passes the gross notional amount threshold.
Major Swap Participant	All asset classes	For MSPs that meet the MSP criteria in the fourth quarter of 2012, on either: (1) the date on which the MSP submits a registration application after December 31, 2012, but before February 28, 2013 <sup>19</sup> or (2) February 28, 2013.
		For MSPs that meet the criteria during a quarter in 2013 or later, on either: (1) the date on which the MSP submits a registration application before it is required or (2) the last day of the second month following the end of the quarter in which the MSP first meets the criteria.
Non-SD; Non-MSP	All asset classes	April 10, 2013

### Reporting of Cleared Swaps

In addition to clarifying the compliance dates for swap data reporting, the CFTC responded to a series of frequently asked questions regarding the reporting of cleared swaps.<sup>20</sup> Most of the CFTC's responses relate to technical reporting requirements for derivatives clearing organizations (DCOs). The guidance addresses, among other things, which party will send selected data to the swap data repository, whether registered entities and counterparties may contract with third parties to facilitate reporting, and whether non-US dollar swaps data should additionally provide a USD equivalent.

### Conclusion

As the CFTC continues to implement its new regulatory regime over swaps, it is likely that additional no action letters and interpretive guidance will be forthcoming. Moreover, it is expected that the CFTC will publish rules or guidance

on the following subjects by the end of the year: (i) extraterritoriality; (ii) clearing determinations; (iii) transparency and rules on swap execution facilities, Core Principle 9, “made available to trade” determinations, and block trades.

Latham & Watkins will continue to monitor the CFTC’s activity and will provide clients with periodic updates of noteworthy developments in this area.

#### **Endnotes**

- <sup>1</sup> 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 (Aug. 13, 2012).
- <sup>2</sup> See *id.*
- <sup>3</sup> See Frequently Asked Questions (FAQ) – Division of Swap Dealer and Intermediary Oversight Response to FAQs About Swap Entities, available at: [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/swapentities\\_faq\\_final.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/swapentities_faq_final.pdf)
- <sup>4</sup> See CFTC No-Action Letter No. 12-22 (Oct. 12, 2012).
- <sup>5</sup> See CFTC No-Action Letter No. 12-21 (Oct. 12, 2012).
- <sup>6</sup> See CFTC No-Action Letter No. 12-16 (Oct. 12, 2012), p. 3.
- <sup>7</sup> See CFTC No-Action Letter No. 12-18 (Oct. 12, 2012).
- <sup>8</sup> See CFTC Letter No. 12-17 (Oct. 12, 2012).
- <sup>9</sup> See CEA Section 1a(10).
- <sup>10</sup> See CFTC No-Action Letter No. 12-14, pp. 4-5 (October 11, 2012).
- <sup>11</sup> See CFTC Letter No. 12-13, pp. 4-5 (Oct. 11, 2012).
- <sup>12</sup> See CFTC Letter No. 12-27 (Oct. 5, 2012). The CFTC also recently published two no-action letters finding that the general partner of a commodity pool was not required to register as a CPO where: (1) the general partner and the designee are under common ownership and control; (2) the general partner has delegated all of its investment management authority to the designee; and (3) the general partner does not engage in the solicitation of investors for the pool and does not manage property of the pool. See CFTC No-Action Letter Nos. 12-24 (Sept. 24, 2012) 12-25 (Sept. 14, 2012). This relief was conditioned on the general partner and designee executing an agreement to be jointly and severally liable for any violations of the CEA or CFTC rules
- <sup>13</sup> See DSIO Responds to Frequently Asked Questions – CPO/CTA: Amendments to Compliance Obligations, available at: [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/faq\\_cpocta.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/faq_cpocta.pdf)
- <sup>14</sup> See Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 FR 11252 (Feb. 24, 2012).
- <sup>15</sup> See Proposal to Exempt Certain Transactions Involving Not-For-Profit Electric Utilities, 77 Fed. Reg. 50998 (Aug. 23, 2012).
- <sup>16</sup> See Proposed Order and Request for Comment on Petition from Certain Independent System Operators and Regional Transmission Organizations to Exempt Specified Transactions Authorized by a Tariff or Protocol Approved by the Federal Energy Commission or the Public Utility Commission of Texas From Certain Provisions of the Commodity Exchange Act Pursuant to the Authority Provided in Section 4(c)(6) of the Act, 77 Fed. Reg. 52138 (Aug. 28, 2012)
- <sup>17</sup> See CFTC Letter 12-11 (Oct. 11, 2012); CFTC Letter 12-12 (Oct. 11, 2012).
- <sup>18</sup> See Q&A—On Start of Swap Data Reporting, available at: [http://cftc.gov/ucm/groups/public/@newsroom/documents/file/startreporting\\_qa\\_final.pdf](http://cftc.gov/ucm/groups/public/@newsroom/documents/file/startreporting_qa_final.pdf)
- <sup>19</sup> If an MSP were to submit its application before January 10, 2013, however, it would not be required to report equity, FX, or other commodity swaps until that date.
- <sup>20</sup> See Frequently Asked Question on the Reporting of Cleared Swaps, available at: [http://cftc.gov/ucm/groups/public/@newsroom/documents/file/clearedswapreporting\\_faq\\_final.pdf](http://cftc.gov/ucm/groups/public/@newsroom/documents/file/clearedswapreporting_faq_final.pdf)

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