

# CLIENT UPDATE

## CFTC GRANTS TEMPORARY RELIEF FROM INCLUSION OF CERTAIN TRANSACTIONS IN DETERMINING SD, MSP, CPO OR CTA STATUS

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On October 12, 2012, the Commodity Futures Trading Commission (the "CFTC"), in four separate no-action letters, granted temporary no-action relief from the requirements to include certain agreements, contracts or transactions in the calculation of: (1) the aggregate gross notional amount of swaps connected with a person's swap dealing activity for purposes of determining whether such person is eligible for the de minimis exception from swap dealer ("SD") registration set forth in Section 1.3(ggg)(4)<sup>1</sup> and (2) a person's substantial position in swaps or substantial counterparty exposure for purposes of determining if such person is a major swap participant ("MSP") under Section 1.3(hhh). In the absence of the relief provided by these no-action letters, a person would be required to include those agreements, contracts and transactions entered into on or after October 12, 2012, in determining whether such person is eligible for the de minimis exception from SD registration or whether such person is an MSP.

Additionally, the CFTC granted temporary no-action relief from the registration requirements of the Commodity Exchange Act ("CEA") to persons who would otherwise be required to register as a "commodity pool operator" ("CPO") or "commodity trading advisor" ("CTA") solely as a result of their foreign exchange swap and forward activities.

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<sup>1</sup> Unless otherwise specified, section references are to the regulations of the CFTC.

## BACKGROUND

The joint final rules issued by the CFTC and the Securities and Exchange Commission defining the term “swap” (the “product definition rules”) became effective on October 12, 2012. As a result, all swaps entered into by a person on or after that date in connection with the person’s swap dealing activities are relevant in determining whether the person must register as a SD. In addition, all swaps that remain outstanding on or after that date are relevant in determining whether the person is an MSP.

Section 1.3(ggg)(4)(i) provides a de minimis exception (the “De Minimis Exception”) from SD registration for any person that, starting on October 12, 2012, enters into swaps positions connected with its swap dealing activities, the aggregate notional amount of which does not exceed either of the two thresholds. The two thresholds are:

- \$3 billion, subject to an initial phase-in level of \$8 billion (the “General De Minimis Threshold”); and
- \$25 million with regard to swaps in which the counterparty is a “special entity” as defined in Section 4s(h)(2)(C) of the CEA (the “Special Entity De Minimis Threshold”).

## SWAPS ENTERED INTO BY UTILITY SPECIAL ENTITIES

The first no-action letter<sup>2</sup> is issued in response to a petition (the “Petition”) requesting that Section 1.3(ggg)(4) be amended to exclude from the Special Entity De Minimis Threshold the notional amounts of swaps to which certain “utility special entities”<sup>3</sup> are counterparties and which are related to their utility operations.

The CFTC issued a no-action relief providing that the Division of Swap Dealer and Intermediary Oversight (the “Division”) will not recommend enforcement action to the CFTC against a person for failure to apply to register as an SD if:

- the “utility commodity swaps” (as defined below) connected with the person’s swap dealing activities which the person (or any other entity controlling, controlled by or

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<sup>2</sup> CFTC Letter No. 12-18, Staff No-Action Relief: Temporary Relief from the De Minimis Threshold for Certain Swaps with Special Entities.

<sup>3</sup> For purposes of this no-action relief, the term “utility special entity” means any special entity that owns or operates electric or natural gas facilities or operations (or anticipated facilities or operations), supplies natural gas and/or electric energy to other utility special entities, has public service obligations (or anticipated public service obligations) under federal, state or local law or regulation to deliver electric energy or natural gas service to utility customers, or is a federal power marketing agency under Section 3 of the Federal Power Act (16 U.S.C. 796(19)).

under common control with the person (an “Affiliate”)) enters into over the course of the immediately preceding 12 months (or following October 12, 2012, if that period is less than 12 months) have an aggregate gross notional amount of no more than \$800 million;

- the person is not otherwise within the definition of the term “swap dealer,” as provided in Section 1.3(ggg) (i.e., the person, or an Affiliate of the person, has not entered into swaps as a result of its swap dealing activities in excess of (i) the General De Minimis Threshold or (ii) the Special Entity De Minimis Threshold (not counting utility commodity swaps)); and
- the person is not a “financial entity,” as defined in Section 2(h)(7)(C)(i) of the CEA.

The term “utility commodity swap” means any swap that meets all of the following conditions:

- a party to the swap is a utility special entity;
- such utility special entity is using the swap in the manner described in Section 1.3(ggg)(6)(iii) (which provides for the exclusion of certain types of swaps used to hedge a physical position from the analysis of whether a person is a swap dealer);<sup>4</sup> and
- the swap is related to an exempt commodity (generally, an energy or metal commodity) in which both parties to the swap transact as part of the normal course of their physical energy businesses.

Any person wishing to rely on this no-action relief must apply by an email notification to the Division at [dsionoaction@cftc.gov](mailto:dsionoaction@cftc.gov) no later than December 31, 2012. The email notification must indicate the identity of the utility special entities with which the person has entered into utility commodity swaps connected with the person’s swap dealing activities and, with respect to each utility special entity, the total gross notional value of such utility commodity swaps. After December 31, 2012, such person must provide an updated email notification on a quarterly basis to the same email address.

This no-action relief will remain in effect until the effective date of any CFTC action with respect to the Petition, including a rulemaking, an order or a determination not to take action with respect to the Petition.

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<sup>4</sup> In the no-action letter, the CFTC clarifies that any guidance regarding Section 1.3(ggg)(6)(iii), including that in the adopting release accompanying the final rules defining the term “swap dealer,” also applies to this no-action relief.

## SWAPS IN AGRICULTURAL AND EXEMPT COMMODITIES

The second no-action letter<sup>5</sup> provides that the Division will not recommend enforcement action to the CFTC against any person for failure to include, in its calculation of the aggregate gross notional amount of swaps connected with its swap dealing activity for purposes of Section 1.3(ggg)(4), a swap that (1) references an agricultural commodity (as defined in Section 1.3(zz)) or an exempt commodity (i.e., a commodity that is not an excluded commodity, as defined in Section 1a(13) of the CEA, or an agricultural commodity) and (2) is executed prior to October 20, 2012.

This no-action relief applies only with respect to swaps that are executed or traded on an electronic trading facility (i.e., an “exempt commercial market” (“ECM”)). To the extent that an agreement, contract or transaction executed on an ECM is not a swap, then no-action relief is not needed.<sup>6</sup>

Additionally, with respect to the MSP determination, the no-action letter provides that the Division will not recommend enforcement action against any person for failure to include, in its calculation of daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure for purposes of Section 1.3(jjj)(4), such exposures arising from any swap that references an exempt commodity or agricultural commodity, from October 12, 2012 through October 20, 2012, inclusive. In other words, the exposures resulting from any swap referencing an exempt or agricultural commodity may be excluded from the daily average calculation until after October 20, 2012.

Both of these no-action reliefs were granted to give parties to swaps referencing agricultural and exempt commodities sufficient time to determine whether and in what manner to best transition their current business practices to the new regulatory environment and to ensure that such transition proceed in an orderly manner.

## FOREIGN EXCHANGE SWAPS AND FOREIGN EXCHANGE FORWARDS

The CEA provides that foreign exchange forwards and foreign exchange swaps are to be considered “swaps” under the swap definition unless the Secretary of the Treasury (the “Secretary”) issues a written determination that either or both: (1) should not be regulated as swaps, and (2) are not structured to evade the Dodd-Frank Wall Street Reform and

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<sup>5</sup> CFTC Letter No. 12-20, Time-Limited No-Action Relief: Swaps in Agricultural and Exempt Commodities Not to be Considered in Calculating Aggregate Gross Notional Amount for Purposes of Swap Dealer De Minimis Exception and Calculation of Whether a Person is a Major Swap Participant.

<sup>6</sup> In other words, reliance on this no-action relief does not require any determination beforehand that an agreement, contract or transaction executed or traded on an ECM is a swap or not.

Consumer Protection Act. For this purpose, a “foreign exchange forward” is defined as a transaction that solely involves the exchange of two different currencies on a specific date at a fixed rate agreed upon at the inception of the contract. A “foreign exchange swap” is defined as a transaction that solely involves (1) the exchange of two different currencies on a specific date at a fixed rate agreed upon at the inception of the contract and (2) a reverse exchange of the currencies involved in the contract at a later date at a fixed rate agreed upon at the inception of the contract.

The Secretary has published a proposed determination to exempt both types of transactions from the swap definition but has not yet issued a final determination. Unless the Secretary issues a final determination exempting such transactions from the swap definition, a person would be required to include all foreign exchange swaps and foreign exchange forwards entered into (or still outstanding) on or after October 12, 2012, in determining whether it must register as an SD or MSP.

This third no-action letter<sup>7</sup> provides that the Division will not recommend enforcement action to the CFTC against an entity for failure to include, in its calculation of the aggregate gross notional amount of swaps connected with its swap dealing activity for purposes of the De Minimis Exception from SD registration, any foreign exchange swap or foreign exchange forward that is covered by an exemption by the Secretary that is effective prior to December 31, 2012. However, the no-action letter provides that, notwithstanding the foregoing, if by December 31, 2012, an entity enters into other types of swaps in connection with its swap dealing activities in excess of either the General De Minimis Threshold or the Special Entity De Minimis Threshold, then such foreign exchange swaps and foreign exchange forwards must be considered for purposes of the entity’s determination of the date by which it must apply to be registered as a SD.<sup>8</sup>

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<sup>7</sup> CFTC Letter No. 12-21, Time-Limited No-action Relief: Foreign Exchange Swaps and Foreign Exchange Forwards Not to be Considered in Calculating Aggregate Gross Notional Amount for Purposes of Swap Dealer De Minimis Exception or in Calculating Substantial Position in Swaps or Substantial Counterparty Exposure for Purposes of the Major Swap Participant Definition; Time-Limited No-action Relief for persons that meet the definition of Commodity Pool Operators and Commodity Trading Advisors Solely as a Result of their Foreign Exchange Swap and Foreign Exchange Forward Activities.

<sup>8</sup> As an example, the CFTC notes that an entity that, in the month of October 2012 (following October 12, 2012), enters into foreign exchange swaps in connection with its swap dealing activities with an aggregate gross notional amount of \$5 billion, and also enters into interest rate swaps in connection with its swap dealing activities with an aggregate gross notional amount of \$4 billion, and if the Treasury Secretary determines to exclude such foreign exchange swaps from the swap definition with an effective date of November 15, 2012, the entity may disregard all such excluded foreign exchange swaps for purposes of such gross notional amount calculation. However, if in the month of November, the entity enters into interest rate swaps in connection with its swap dealing activities with an aggregate gross notional amount of \$5 billion, then its foreign exchange swaps must be considered for purposes of determining the date by which it must register as a swap dealer. In this case, the entity must apply to be registered by or before December 31,

Additionally, the same no-action letter provides that the Division will not recommend enforcement action to the CFTC against an entity for failure to include, in its calculation of its substantial position in swaps or substantial counterparty exposure for purposes of determining whether it is an MSP, any foreign exchange swap or foreign exchange forward that is covered by an exemption by the Secretary that is effective prior to December 31, 2012.

Finally, the no-action letter provides that the Division will not recommend enforcement action to the CFTC against an operator of a collective investment vehicle that trades foreign exchange swaps and forwards or a person who provides advice concerning foreign exchange swaps and forwards and that would have to register with the CFTC as a commodity pool operator or commodity trading advisor solely as a result of these respective activities, for failure to so register, if the Secretary issues a final determination effective before December 31, 2012.

#### **SWAPS BETWEEN CERTAIN NON-U.S. PERSONS**

The fourth no-action letter<sup>9</sup> provides that the Division will not recommend enforcement action to the CFTC against any person that is not a Designated U.S. Person (as defined below) for failure to include a swap executed prior to the earlier of December 31, 2012, or the effective date of the definition of a “U.S. person” in a final Exemptive Order Regarding Compliance with Certain Swap Regulations, in its calculation of the aggregate gross notional amount of swaps connected with its swap dealing activity for purposes of determining its eligibility for the De Minimis Exception, so long as the counterparty to such swap is also not a Designated U.S. Person.

A “Designated U.S. Person” includes any person that is:

- A natural person who is a resident of the United States;
- 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 (each such entity, a “U.S. Business Entity”);

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2012, because it has entered into interest rate swaps in connection with its swap dealing activities that exceeded the General De Minimis Threshold of \$8 billion before December 31, 2012.

<sup>9</sup> CFTC Letter No. 12-22, Time-Limited No-Action Relief: Swaps Only With Certain Persons to be Included in Calculation of Aggregate Gross Notional Amount for Purposes of Swap Dealer De Minimis Exception and Calculation of Whether a Person is a Major Swap Participant.

- A pension plan for employees, officers or principals of a U.S. Business Entity (unless the pension plan is exclusively for foreign employees of such entity);
- An estate or trust, the income of which is subject to U.S. income tax regardless of source; or
- An individual account (discretionary or not) where the beneficial owner is a person described in any of the four foregoing items.
- The no-action letter provides that, for purposes of this no-action relief, a person may reasonably rely on the representations of its counterparty regarding whether such counterparty is or is not a Designated U.S. Person. Moreover, this no-action relief will apply where the counterparty is not a Designated U.S. Person regardless of whether the counterparty's obligations under the swap are guaranteed by a person that is a Designated U.S. Person.

Additionally, the no-action letter provides that the Division takes the same position with respect to the determination of whether a person is an MSP. Therefore, it will not recommend enforcement action to the CFTC against any person that is not a Designated U.S. Person for failure to include a swap executed prior to the earlier of December 31, 2012, or the effective date of a definition of "U.S. Person" in a final Exemptive Order Regarding Compliance with Certain Swap Regulations, in its calculation of whether it is an MSP for purposes of Section 1.3(hhh), so long as the counterparty to such swap is also not a Designated U.S. Person.

Finally, the no-action letter provides that the same relief (with regard to both the SD and the MSP determinations) will apply to swaps entered into by a person that is not a Designated U.S. Person where its counterparty is a foreign branch of a person that is a Designated U.S. Person, which meets the definition of an SD and has represented that it intends to register with the CFTC as an SD by March 31, 2013.

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Please do not hesitate to contact us if you have any questions.

October 19, 2012