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Investment Management Hot Topics

CFTC Update: What Fund Managers Need to Know

October 23, 2012

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1. About the Speakers

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Ida Wurczinger Draim focuses her practice on securities and commodities compliance counseling and the representation of securities industry and corporate clients in regulatory investigations and proceedings. With more than 25 years of experience, Ida is well known for her expertise in investment adviser and broker-dealer compliance and her highly effective representation of industry clients before the SEC, NYSE, FINRA, CFTC, NFA and other regulatory authorities.

Some of the areas that Ida regularly addresses on behalf of our investment adviser clients include conflicts of interest, Form ADV disclosure, third-party marketing arrangements, soft dollar practices, personal trading compliance, principal and agency trades, advertising, valuation, best execution, custody, trading restrictions and prohibitions, and commodity pool operator registration and regulatory issues. In the broker-dealer context, Ida regularly deals with Regulations NMS and SHO, best execution, dark pools, prime brokerage functions, institutional and retail sales practices, insider trading and rumors, marketing materials, research, short sale restrictions, supervisory structure, trade surveillance and monitoring, and statutory disqualifications. In addition to compliance counseling and regulatory representation, Ida routinely supervises mock audits, advises clients undergoing regulatory examinations and inspections, provides compliance training and develops supervisory and compliance policies and procedures.

One of Ida's strengths is her experience with securities regulation from both sides of the aisle. After several years as a securities litigation associate with a Wall Street law firm, Ida joined the SEC, first serving as staff attorney in the Division of Enforcement, where she earned a Special Achievement award, then as Special Counsel to SEC Chairman John Shad. Ida is a member of the FINRA (formerly, NASD) Board of Arbitrators and Board of Mediators and, for 10 years, served as a member of the Nasdaq Listing Qualifications Panel. She is also a panelist and member of the Securities Industry and Financial Markets Association (SIFMA) Legal and Compliance Division and a former Chair of the Corporation, Finance and Securities Law Section of the District of Columbia Bar.

Ida is an active speaker and writer. She co-authored the chapter "Protecting Your Firm Through Policies and Procedures, Training and Testing" in the Insider *Trading Law and Compliance Answer Book* published in 2011 by the Practising Law Institute and "Trade Reporting and Compliance" in the *Practitioner's Guide for Broker-Dealers* published by Complinet. She recently participated in the NFA Workshop for Commodity Pool Operators, the MFA Quarterly Investor Relations and Business Development Forum and SRZ's 21st Annual Private Investment Funds Seminar.

Ida received her J.D. from Harvard Law School and her B.A., *cum laude*, from Rutgers University.

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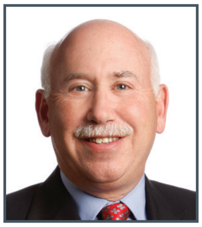
David J. Efron practices in the areas of domestic and offshore hedge funds, including fund formations and restructurings. Additionally, he advises hedge fund managers on structure, compensation and various other matters relating to their management companies, and structures seed capital and joint venture arrangements. David also represents hedge fund managers in connection with SEC regulatory issues and compliance-related matters.

David is listed in *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and has been recognized by *The Legal 500 United States* as "an extraordinarily capable attorney. He has a mastery of the pertinent matters, but he also brings a pragmatic approach."

A published author on subjects relating to investment management, David is a sought-after speaker for hedge fund industry conferences and seminars, and a frequent guest lecturer at New York-area law schools. Some of his recent presentations include "Potential Impact of JOBS Act on Hedge Fund Industry" and "Regulatory Developments in 2012 — U.S. Focus," which he delivered at the International Bar Association's 13th Annual International Conference on Private Investment Funds.

David received his LL.M. in securities regulation, with distinction, from Georgetown University Law Center, his J.D. from Syracuse University College of Law and his B.A. from Vassar College.



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Kenneth S. Gerstein focuses his practice on representing investment advisers, broker-dealers and banks in connection with the organization and operation of investment funds, including mutual funds, hedge funds, closed-end investment companies, business development companies and bank collective investment funds. He also represents these firms in connection with the development of other types of investment-related products and services. Ken has worked with clients in developing novel hybrid fund products, including registered hedge funds and registered hedge funds of funds. He also advises clients on a broad range of securities regulatory and compliance matters, and represents mutual fund independent directors. Prior to entering private practice, Ken served as special counsel in the SEC's Division of Investment Management in Washington, DC.

Ken is a frequent author and speaker on issues related to investment funds and investment advisers, having appeared at conferences sponsored by the Practising Law Institute, ALI-ABA, the Investment Company Institute and other organizations. He is a member of the American Bar Association's Committee on the Federal Regulation of Securities and its Subcommittee on Investment Companies and Investment Advisers, and is a member of the New York City Bar Association's Committee on Investment Management Regulation.

Ken obtained an LL.M. from Georgetown University Law Center, a J.D. from the James E. Beasley School of Law at Temple University, where he was a member of the *Temple Law Quarterly*, and a B.S. in economics from the Wharton School of the University of Pennsylvania.

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Jacob Preiserowicz focuses his practice on counseling commodity pool operators, commodity trading advisers, other commodity professionals and private investment fund managers on operational, regulatory and compliance matters. He regularly advises hedge and private equity fund managers with respect to the U.S. Commodity Futures Trading Commission's exemptions, registration and reporting requirements and compliance with the requirements of the National Futures Association. Jacob conducts training sessions with respect to regulatory compliance matters, and helps guide firms through regulatory examinations. He also has expertise in the formation and ongoing operational needs of hedge funds and other private investment funds.

Jacob joined the firm from the CFTC, where he served most recently as Special Counsel in the Division of Swap Dealer and Intermediary Oversight. At the CFTC, he drafted new regulations and worked on a broad range of matters to CFTC registration and compliance.

Jacob earned both J.D. and M.B.A. degrees from Fordham University. He was the Notes & Articles Editor of the *Fordham Journal of Corporate & Financial Law* and received *cum laude* honors from the Fordham University Graduate School of Business. He received his B.A., *cum laude*, from Brooklyn College.

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Craig Stein is co-head of the firm's Structured Products & Derivatives Group. Craig's practice focuses on swaps and other derivative products, including credit- and fund-linked derivatives, prime brokerage and customer trading agreements, and structured finance and asset-backed transactions. He represents issuers, underwriters and portfolio purchasers in public and private structured financings, including collateralized loan obligations (CLOs).

Craig is a sought-after speaker for hedge fund industry conferences and has written widely on advanced financial products. He recently presented "Regulatory and Accounting Challenges and Hurdles" at IMN's 1st Annual CLO and Leveraged Loan Conference and discussed "Leverage for Investment Funds" and "Regulatory and Compliance" at SRZ's 21st Annual Private Investment Funds Seminar. His articles have appeared in publications such as *Credit* magazine, *Loan Market Week*, *Pratt's Journal of Bankruptcy Law* and the *Journal of Derivatives*. He co-authored "New Structural Features for Collateralised Loan Obligations," which appeared in *The International Comparative Legal Guide to: Securitisation 2012*, and "Dodd-Frank — One Year On" for the *International Financial Law Review*.

Craig is a member of the American Bar Association, the New York State Bar Association and the ISDA Credit Derivatives Market Practice Committee. He has been recognized by the prestigious legal directory *Chambers USA*, which stated: "Clients and peers have 'nothing but great things to say about' him. He is 'a great thinker and excellent credit derivatives operator.' "

Craig earned his J.D., *cum laude*, from the University of Pennsylvania Law School and his B.A., *cum laude*, from Colgate University.

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Joseph Suh focuses on corporate and securities matters related to investment funds and financial products. He primarily represents investment managers, financial services firms, private investment funds and charitable foundations and other institutional investors, advising his clients in connection with the structuring of, or investments in, private investment funds (including hedge funds and funds of hedge funds), structured finance vehicles (including CLOs) and financial products (such as structured notes, credit derivatives, equity derivatives, total return swaps, fund-linked derivatives and fund-linked notes).

Joseph, who speaks Portuguese and lived in Brazil for nine years, coordinates SRZ's Latin American client practice efforts, focusing primarily on the Brazilian investment management industry. His investment management clients include U.S. managers offering investment funds to Brazilian investors and Brazilian managers offering private investment funds to U.S. investors. He advises them in structuring the investment funds and in connection with all related U.S. corporate, securities and investment adviser regulatory issues.

Joseph is a member of the Banking & Capital Markets Committee and the Trade & Business Investment Committee of The Brazilian-American Chamber of Commerce, the Securities Regulation Committee of the New York State Bar Association and its Private Investment Fund Subcommittee, the Derivatives and Structured Products Law Committee of the New York State Bar Association, the Managed Funds Association Outside Counsel Forum and the Thomson Reuters Business Law Partner Advisory Board.

A frequent writer and speaker in his area of expertise, Joseph recently co-authored "Focus On: US Investors in LatAm," which appeared in *LatAm Fund Manager*, and he wrote "Negotiating FCM Client-Account Agreements for Cleared OTC Derivatives" for *Thomson Reuters Accelus*. He moderated and spoke at the Brazilian-American Chamber of Commerce panel on "Challenges and Opportunities in Investing in Brazilian Infrastructure, Small and Mid-Cap Companies, High Yield Bonds and M&A" and spoke on "Raising Capital in the USA," at DMS Management's second annual Offshore Investment Funds Summit in São Paulo. Joseph is frequently quoted by newspapers, trade publications and journals, including *American Banker*, *Total Securitization* and the Fox Business Network, on a wide variety of issues in the investment and structured products industries.

Joseph obtained his J.D. from Fordham University School of Law, where he was associate editor of the *Fordham Law Review*, and his undergraduate degree from Cornell University.

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2. PowerPoint Presentation

Commodity Pool Operators

CFTC Exemptions and Registration

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Notes:

CFTC Actions Relating to CPO Exemptions

- Rescission of Rule 4.13(a)(4)
- Amendment of Rule 4.5
- Inclusion of swaps as “commodity interests”

Notes:

Commodity Pools and CFTC Regulation

- What is a commodity pool?
- What is a CPO?
- What is a CTA?

Notes:

Available Exemptions: Rule 4.13(a)(3)

- Available to privately offered funds
- Limited to "accredited investors"
- Alternative de minimis tests
- Cannot be marketed as vehicle for trading commodities

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Notes:

Available Exemptions: Rule 4.5

- Available to 1940 Act registered funds
- Alternative de minimis tests
- Bona fide hedging transactions excluded from the tests
- Cannot be marketed as vehicle for trading commodities

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Notes:

Practical Issues

- Complying with the de minimis tests
- Issues for funds of funds
- Compliance procedures

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Notes:

Other Available Exemptions

- Rule 4.13(a)(2) — proprietary pools
- Family offices
- CTA exemptions

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Notes:

The Registration Process

- What entity needs to register?
- Registration of associated persons and principals
- Exam requirements
- Timing

Notes:

Post-Registration Requirements

- Rule 4.7
- Rule 4.12(b)
- Disclosure requirements
- Form CPO-PQR
- Issues for registered funds

Notes:

CFTC Swap Rules

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Notes:

Swap Clearing Requirements

- Mandatory clearing
- Risks
- Eligible collateral
- Documentation

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Notes:

Position Limits Aggregation Rules

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Notes:

Swap Documentation Requirements

Trading Relationship and Confirmations

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Notes:

ISDA Dodd-Frank Protocols

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Notes:

Reporting and Recordkeeping

- Reporting counterparty
- Timing
- Recordkeeping requirements

Notes:

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3. Commodity Pool Operators: CFTC Exemptions and Registration

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Commodity Pool Operators: CFTC Exemptions and Registration

I. CFTC Current Status for CPO Registrations/Exemptions

In April, the Commodity Futures Trading Commission ("CFTC") rescinded the Rule 4.13(a)(4) exemption from registration as a commodity pool operator ("CPO"), an exemption which the majority of the private fund industry relied upon. The exemption will no longer be available as of Jan. 1, 2013. Thus, private fund managers need to consider whether they can rely on an alternative exemption (the primary one being the Rule 4.13(a)(3) de minimis exemption), or must register with the CFTC as a CPO

The CFTC also amended Rule 4.5, which provides an exemption from CPO registration to investment companies registered under the Investment Company Act of 1940. Prior to the amendment, Rule 4.5 did not impose any restrictions on the use of commodities by registered funds claiming the exemption. Rule 4.5, as amended, is similar to amended Rule 4.13(a)(3) in that registered funds can claim the exemption only if they satisfy one of the two available de minimis tests. However, unlike Rule 4.13(a)(3), Rule 4.5 allows registered funds to exclude bona fide hedging transactions for purposes of the de minimis tests. Registered funds will need to comply with amended Rule 4.5 beginning on Jan. 1, 2013. However, the Investment Company Institute and the U.S. Chamber of Commerce have commenced a legal action in the U.S. District Court for the District of Columbia seeking to overturn the CFTC's action amending the rule. That litigation is still ongoing

To complicate matters further, effective Oct. 12, 2012, "swaps" became subject to the CFTC's jurisdiction and are considered "commodity interests." As a result, fund managers that seek to rely either on Rule 4.13(a)(3) or Rule 4.5 de minimis exemption must treat certain types of swaps as commodity interests for purposes of the de minimis tests set forth in those rules

II. What Is a Commodity Pool?

A. Only managers of "commodity pools" must register as CPOs or claim an exemption from registration

B. However, the term "commodity pool" is broadly defined by the CFTC. Generally, the CFTC considers any pooled investment fund to be a commodity pool if it trades even one commodity interest

1. A fund that trades no commodity interests is not a commodity pool. Such a fund can still trade security-based swaps

2. A fund of one that has received capital contributions from one person also is not a commodity pool (although any capital contributions from any general partner of the fund may be considered an additional person). (However, the manager of such a fund that trades commodity interests must consider whether registration as a commodity trading advisor ("CTA") is required or an exemption from CTA registration is available)

3. Funds of funds that do no direct trading, thus do not trade in any commodity interests, are still considered commodity pools if any investee fund does such trading)

4. Based on a recent CFTC no-action letter, certain securitization vehicles are no longer treated as commodity pools. However, the relief afforded by this letter wouldn't necessarily be available for certain vehicles such as CLOs and CDOs. The CFTC staff indicated in its letter that it remains open to discussion regarding future relief for additional types of securitization vehicles. Managers of such vehicles are seeking to obtain such relief before Dec. 31, 2012, the date by which registration would be required

5. The CFTC has also taken the position that SPVs are commodity pools. Generally, the CFTC takes the position that separate legal entities are pools and does not view separate share classes as separate pools

III. Exemptions

A. The Rule 4.13(a)(4) exemption allowed unlimited commodity interest trading by a pool in which all investors were qualified eligible persons ("QEPs"). In contrast, a pool seeking to rely on Rule 4.13(a)(3) (which can be offered to accredited investors) must limit its trading of commodity interests by meeting one of the two de minimis tests set forth in the rule. Rule 4.5 does not impose restrictions on the types of investors in a registered fund relying on that rule, but requires that the rule's de minimis tests be met

B. Requirements of Rule 4.13(a)(3) and Rule 4.5

1. In addition to satisfying the de minimis tests, a fund seeking to rely on Rule 4.13(a)(3) or Rule 4.5 cannot be marketed as a vehicle for trading commodity futures or commodity options. In addition, under Rule 4.13(a)(3), a fund must be offered in a private placement, cannot be marketed to the public and all investors in the fund must be accredited investors or QEPs

2. De minimis tests: At all times, a fund relying on the Rule 4.13(a)(3) exemption must remain below one of two thresholds: either (i) the aggregate initial margin required to enter into a commodity interest transactions (including premiums paid for commodity options) cannot exceed 5 percent of NAV or (ii) the net notional value of such positions cannot exceed 100 percent of NAV. For purposes of the latter test, "notional value" means the full notional value of an instrument (even though that amount can be particularly high in certain instances). Further, uncleared swaps cannot be netted. Rule 4.5 imposes the same de minimis tests. However, under Rule 4.5, a registered fund does not have to include commodity interests used for "bona fide hedging" in determining whether it meets the tests

3. The CFTC has narrowed the definition of "bona fide hedging." That definition was included in the CFTC's recently adopted rule regarding position limits. Although the CFTC's adoption of its rule on position limits has been overturned by the U.S. District Court for the District of Columbia, the CFTC staff recently issued an interpretation stating that it nonetheless views the definition of bona fide hedging contained in the position limits rule as applicable to Rule 4.5

4. Commodity interests for purposes of the de minimis tests include (i) futures contract and options on such contracts, (ii) retail forex (FX transactions offered to retail investors) and (iii) CFTC regulated swaps. Swaps regulated by the CFTC include (i) swaps on CFTC regulated instruments (i.e., commodity futures and currency related swaps), (ii) swaps on broad-based indexes and (iii) FX forwards (currently, both deliverable and non-deliverable). The market on which or locality in which an instrument is traded, and the location of the swap counterparties, are irrelevant for the de minimis tests and all such commodity interests must be counted

5. If a fund manager operates even one pool which does not qualify for an exemption, the fund manager is required to register as a CPO. However, that does not preclude the manager from claiming an exemption on behalf of other pools and treating those pools as exempt

6. Currently, the only safe harbor for crossing the de minimis thresholds is that a fund would be permitted to get back under a threshold before entering into another trade. This is not very useful for most fund managers

7. Because Rule 4.13(a)(3) and Rule 4.5 are only available to fund managers that make limited use of commodity interests, the exemptions are useful for fund managers that do not use such interests on a regular basis or can keep their use of commodity interests comfortably below one of the thresholds. Managers of funds that are consistently below, but close to, the thresholds should consider whether registration would be appropriate by weighing the costs, burdens and benefits of CPO registration versus the detriment of limiting transactions in commodity interests. If a manager is limiting trades to stay below thresholds, consideration should be given to whether this can be expected to impact adversely fund performance. If that is the case, adding risk disclosure of this fact to the fund's offering memorandum or prospectus may be appropriate

8. Funds of funds: For a private fund of funds to rely on Rule 4.13(a)(3), certain representations must be obtained from all underlying funds in which it invests to assure that the fund of funds

meets one of the situations described in Appendix A to Part 4. Although Appendix A was deleted from the regulations, the CFTC has indicated that funds of funds may still rely on Appendix A. As a practical matter, it is very difficult for funds of funds to qualify for the Rule 4.13(a)(3) exemption. A fund of funds seeking to rely on Rule 4.13(a)(3) should (i) obtain representations that all underlying funds are relying on the de minimis exemption or (ii) obtain representations from underlying funds as the maximum level of initial margin (and premiums) as a percentage of NAV that they will commit to commodity interests and then multiply those percentages by the percentage of the fund of fund's NAV invested in each of those underlying funds as a basis for determining whether the fund of funds is itself below the 5 percent threshold

(a) As a technical matter, Appendix A is not applicable to registered funds of funds seeking to rely on Rule 4.5. However, registered funds can apply the approach of Appendix A in determining whether the Rule 4.5 exemption is available. In making such determination, a registered fund of funds can seek information from underlying funds as to whether and, if so, to what extent underlying funds are trading in commodity interests for bona fide hedging purposes and exclude trading for such purposes when calculating the 5 percent de minimis threshold

C. Rule 4.13(a)(2): proprietary pools. While 4.13(a)(2) is a "small pool" exemption, limited to 15 persons and $400,000, those limits do not require counting the number of principals, or their investments, toward these limitations. Rule 4.13(a)(2) may be useful for proprietary pools

D. Rule 4.5 litigation: As noted above, there is pending litigation that may result in a decision overturning the amendment of Rule 4.5. Because there is no way to predict the outcome of this litigation, or to predict when the court will issue its decision (although the court will presumably consider the potential impact on registered funds and their managers if a decision is not issued by December 31), registered funds that are not able to rely on Rule 4.5 and their managers need to proceed as if they will become subject to amended rule

E. CTA exemptions. Funds that are remaining exempt and currently rely on Rule 4.14(a)(8) may continue to do so. However, even if an entity is registering as a CPO, it may still have other exemptions to rely upon such as 4.14(a)(4), 4m(3) and 4.14(a)(10). In addition, all sub advisers should ensure that an exemption is available to it (irrespective of whether the sub adviser has investment discretion)

1. 4.14(a)(4) and (5): The adviser only acts as CTA to pools for which you serve as CPO (or exempt CPO) (i.e., no other managed account clients)

2. 4m(3): The adviser: (i) is registered investment adviser ("RIA"), (ii) doesn't hold out to public as CTA and (iii) being a CTA is not a primary part of your business

3. 4.14(a)(10): The adviser: (i) does not hold itself out to public as a CTA and (ii) is limited to 15 clients/funds

4. 4.14(a)(8): The adviser: (i) is an RIA, (ii) provides predominately securities advice and (iii) clients are exempt pools or foreign pools

   (a) 4.14(a)(8) is the only CTA exemption that requires a filing; others are self-executing

IV. CFTC Registration

A. Who must register?

1. In the case of a private domestic fund, the general partner would generally be considered the entity required to register as a CPO. This would also be the case for a private domestic feeder fund in a master-feeder structure. However, since the general partner of a domestic fund generally designates the fund's investment manager as the CPO, both entities are considered CPOs and would be required to register as co-CPOs

(a) Traditionally the CFTC staff has provided no-action relief which allows only the investment manager to register as a CPO. The terms of the letters providing this relief over the course of almost 15 years generally require (i) the delegation of all authority from the GP to the investment manager, (ii) the GP and the investment manager to be under common control, (iii) the GP to have no employees and (iv) the GP and the investment manager to enter into a joint and several liability agreement for violations of the CEA. In a recent issued FAQ, the CFTC staff stated that only the investment manager would be required to register if the GP delegates all CPO authority to the investment manager. This is a somewhat lower standard than what was required with respect to delegation in the no-action letters. However, the FAQ does still require an agreement regarding joint and several liability. This requirement poses a slight tax risk insofar as such an agreement creates another nexus between the GP and the investment manager which may increase the risk of the GP losing the beneficial tax treatment it receives with respect to incentive allocations. Clients should weigh this risk against the costs and burdens of registering both the investment manager and the GP (or multiple GPs if different GPs are used for different funds)

2. In the case of an offshore feeder fund or an offshore master fund, the directors of the fund and the fund's investment manager would be considered co-CPOs

(a) While this is the traditional approach of the CFTC, it may be difficult to get independent directors of a fund to sign a joint and several liability agreement. In addition, there is language in a CFTC no-action letter and in a CFTC release supporting the view that registration of directors and the investment manager may not be necessary. In a 2010 no-action letter, CFTC staff allowed only the investment manager of a fund to register, despite the fact that there was no joint and several liability agreement with the fund's directors, where it was asserted that the independent directors could not sign such an agreement without impairing their independence. Further, in the release amending Rule 4.13(a)(3) and Rule 4.5, rescinding 4.13(a)(4), the CFTC stated that it did not expect the directors of a registered fund to register as CPOs and that the manager of the fund would be the appropriate entity to register

3. For registered funds, the CFTC has clearly stated that a fund's investment manager, rather than its directors, should register as a CPO

B. Registration process

1. Rule 4.13(a)(4) will no longer be available as of Jan. 1, 2013, and Rule 4.5 will become more restrictive as of that date. Fund managers that cannot meet the de minimis tests of those rules will need to be registered as of that date

2. The CFTC staff recently provided no-action relief to CPOs who are registering solely as a result of their swaps activities. Rather than requiring registration by December 31, the CFTC staff is allowing such firms to submit a completed application by that date, despite that it may still take several more weeks for the firms to become registered with the NFA. However, the staff is requiring that such a firm act as if registered pending registration

3. Aside from the firm CPO registration, each principal and associated person ("AP") needs to register and get fingerprinted. APs will also be required to take a proficiency exam. Generally, an AP would take the Series 3 exam, but there are alternative exams or complete waivers available in certain situations

(a) Principals generally include individuals at the executive level, including CCOs, and 10 percent owners. Entities can also be considered principals, but a Form 8-R is not needed for such principals

(b) APs generally include all individuals who solicit clients and their supervisors up the chain. It would generally stop at the head of marketing, but who must register as an AP may depend on a firm's structure (i.e., whether the head of marketing reports on a regular basis to someone more senior). At least one principal of a firm must register as an AP. Furthermore, while the NFA will approve registration of a CPO even if all APs have not yet passed a proficiency exam, that is not the case with the AP/Principal

C. Application form

1. There is also the new concept of "swap firms" and "swaps APs." Virtually every private fund will be a swaps firm, and their APs will be swaps APs. Any fund that enters into just one swap fits this definition. Similarly, to the extent a registered fund uses swaps, the same analysis would be applicable

Proficiency requirement waivers

2. While there are officially two specific criteria under which firms can apply for a waiver, there are essentially three categories of individuals who can apply for a waiver. The waiver process requires a registrant to apply for a waiver and make certain representations with respect to the firm and/or individual

   (a) Limited futures activity: Traditionally, CPOs could get waivers if they represented that they are primarily engaged in securities trading and that commodity futures/commodity options were only used for hedging and risk management purposes. The new waiver option is a bit broader: the CPO would have to make the representation that it would have met de minimis exemption, but for swaps

   (b) Previously registered persons: Many fund managers were previously registered as CPOs before Rule 4.13(a)(4) was adopted, and subsequently deregistered once the rule was adopted. Similarly, there are individuals who left a registrant to join a fund manager relying on an exemption and have been an entity exempt from CPO registration for over two years, which means that their registration as APs will have expired. In such situations, the NFA has shown a willingness to provide at least a partial waiver and to allow such individuals to take the Series 32 exam (a more limited exam focused only on CFTC/NFA regulations) rather than the Series 3 exam

   (c) Funds of funds: While the NFA will not provide waivers simply because a fund of funds engages in no direct trading of commodity interests, it may provide a waiver based on the level of representations that could be made about the investee funds (i.e., strategy, percentage allocation, initial margin levels, etc.)

   (d) Series 7+31: Individuals at an affiliated broker-dealer can rely on the Series 7 and Series 31 exams in lieu of the Series 3 exam

3. Branch managers: Any location where there is an AP is required to be listed as a branch office. (A branch office must also be part of the same legal entity that is registering as a CPO.) Branch managers must take the Series 3 exam (or equivalent). In addition, a branch manager must take the Series 30 exam. However, the NFA will accept the Series 9 and 10 exams, or the Series 24 exam, in lieu of the Series 30. (Thus, a branch manager must take (i) the Series 3, or the Series 7+31 and (ii) the Series 30 or the Series 24 or the Series 9+10)

D. Registration relief

1. Although fund managers that cannot rely on any exemption from registration must register as CPOs, relief may be available from certain requirements applicable to CPOs

   (a) Rule 4.7: "registration lite." In the case of funds where all investors are QEPs, Rule 4.7 is available. The definition of QEP includes qualified purchasers ("QPs"). Thus, private funds relying on Section 3(c)(7) under the Investment Company Act of 1940 can rely on Rule 4.7. Further, the CFTC staff in its FAQ stated that fund managers in such a situation will not have to reconfirm that its investors are QPs

      (i) Rule 4.7 provides relief from most of the disclosure requirements and some reporting requirements applicable to commodity pools and CPOs

   (b) For funds that cannot rely on Rule 4.7, there is one other registration relief available, Rule 4.12(b). While not as broad a relief as Rule 4.7, Rule 4.12(b) provides relief from certain regulatory requirements that would otherwise be applicable. Although Rule 4.12(b) imposes no restrictions on the type of investors in a fund, it requires a fund to meet a 10 percent initial margin de minimis threshold. Rule 4.12(b) would be helpful for private funds relying on Section 3(c)(1) under the Investment Company Act that have investors who are not QEPs

Rule 4.12(b) provides similar relief to that available under Rule 4.7. However, Rule 4.12(b) imposes requirements with respect to information included in offering memoranda, requires that this information be no more than 9 months old and requires pre-filing with and review by the NFA

2. Post-registration

(a) Bylaw 1101: Bylaw 1101 of the NFA requires each NFA member (all CFTC registrants are NFA members) to ensure that everyone it does business with is an NFA member or are not required to be a member.. While NFA expects this to include a fund's service providers (i.e., prime broker, swap counterparties, etc.), the NFA's primary focus is on investors. Generally, there will be a questionnaire in the subdocs and firms will also follow-up on investor answers to the extent possible by confirming on the NFA's website. Fund managers going through the registration process currently are in a unique situation because many of their investors are also currently going through the registration process or are otherwise still undecided on whether to register. Thus, it may be appropriate for fund managers to wait until January 1 to start its Bylaw 1101 diligence or at least start a bit closer to January 1

(b) Quarterly changes in NAV statements are required, as are audited financial statements within 90 days after the end of the fiscal year. However, a fund manager could apply for an extension past the 90 days

(c) Due to the fact that there are certain conflicts between SEC rules applicable to investment companies and CFTC regulatory requirements, the CFTC has released a "harmonization" proposal with respect to those rules. Therefore, although Rule 4.5 becomes applicable on Jan. 1, 2013, compliance with certain CFTC requirements will not be necessary until 60 days after the harmonization proposal is adopted

(d) CPO-PQR: All registrants are going to be required to file on a quarterly basis the form CPO-PQR, which is similar to the Form PF. For firms that file Form PF, they are exempt from filing most of CPO-PQR, but there is still information which must be completed. Regardless, since most firms will be deferring registration to January 1, the first CPO-PQR filing will not be required until May 2013

(e) The NFA also requires members to review their operations on an annual basis, using the NFA's self-exam checklist

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Investment Management Hot Topics

4. CFTC Swap Rules

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CFTC Swap Rules

I. Swap Clearing Requirements

A. What is OTC derivatives clearing?

1. Derivatives clearing is modeled after exchange trading in which buy and sell orders are matched. In the context of OTC derivatives clearing, this means that the clearing house intermediates trades between ISDA parties. Once the trade clears, the ISDA no longer applies since both parties are facing the clearing house

2. The clearing house, at least theoretically, is guaranteeing the settlement of the trade

3. According to some estimates, 75 percent of all OTC derivative trades are standard enough to be cleared. If this is true, it will dramatically impact the cost of doing OTC derivatives because of clearing house capital requirements

B. What are the benefits to OTC derivatives clearing?

1. The first benefit is a reduction of credit risk. The clearing house is arguably too big to fail. But this really depends on whether the clearing house is properly funded. Currently, clearing house margin amounts are at about 97 percent with intraday margin at about $300–500 billion

2. The second benefit is a reduction of default risk. The clearing house is permitted to call for intraday margin as many times as it deems necessary to be fully secured. Also, the clearing house is continuously running stress testing to maintain appropriate capital requirements for the default fund. For additional protection, the clearing house may obtain insurance coverage from a third party and contribute its own money. Finally, regulators may require clearing houses to provide a minimum of 50 percent of the house capital requirements which will hopefully translate to lower funding costs for the clients and clearing members

3. Another benefit is a reduction of systemic risk. Because the clearing house intermediates the OTC derivatives market, it will isolate the effects of defaulting members. Each clearing house has rules and procedures in place which address what to do if a clearing member defaults. Basically, a typical default waterfall is: terminate or auction trades by collecting bids from remaining clearing members, liquidate margin, draw on the guarantee fund, haircut VM, get more capital from clearing members or use its own money. One concern clearing members have is that the waterfall should not materially burden the non-defaulting clearing members; like ICE, which has forced allocations

C. What are the risks associated with OTC derivatives clearing?

1. With OTC derivatives, clients were exposed to certain readily identifiable risks, such as (1) dealer's credit risk, (2) collateral posting and valuation provisions, (3) termination terms and (4) risks related to the transactions

2. With cleared trades, clients will be exposed to certain additional risks that may be significant to many of them

   (a) Clearing houses only cover a limited scope of products. This means that clients may have to spread their portfolio across multiple clearing houses and OTC dealers

   (b) Clearing houses have complicated Margin Methodologies

      (i) Initial Margin Methodologies. Clearing houses calculate Initial Margin on a multilateral portfolio basis unlike variation margin which is calculated on a trade level which tracks market pricing

(ii) Methodology Terms: Methodology terms can change at will. Clearing houses may change their margin methodologies at any time which may dramatically affect margin and capital funding requirements. Also, some clearing houses may have multiple intraday margin calls which means that the clearing member may charge clients high spreads or house margin to cover their one-day credit risk. Clients are advised to ask their clearing members up front how clearing fees and default fund requirements are being passed through to them

(iii) Margin Multipliers. The next issue with margin is the use of multipliers. Clearing houses will charge upticks for dropping clearing member credit ratings. Clearing house margin methodologies contain risk multipliers which are based on factors such as how bankruptcy-remote the client's positions and margin are. Finally, there are no thresholds, minimum transfer amounts or dispute resolution on margin

(c) Many clearing houses only accept cash and treasuries as collateral

(i) Some clearing houses are now willing to accept high-grade bonds as eligible collateral

(ii) Clients may have to pay for overnight repos to meet margin calls for limited eligible collateral

D. Streamlining the global clearing rules and clearing house rules

1. The EU is having a difficult time with close-out netting and the portability of a bankrupt clearing member's positions because of different local insolvency laws and rules on segregation

2. There are also inconsistencies in who has to clear. In the EU it's financial counterparties and non-financial counterparties clearing above a threshold. In the U.S., the issue is that bank branches are subject to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") but not offshore subsidiaries. In Europe, banks can own clearing houses, which is probably why Europe has 27 clearing houses with 12 in major markets

3. Another issue is whether it would be possible to get all clearing houses on one electronic margining system which will allow clients to net across multiple clearing houses

4. We also need a worldwide standard for eligible collateral

5. All clearing houses should use the same stress-testing models, one calculation for position/concentration limits and the same waterfall default procedures

II. Position Limits and Aggregation Rules

A. Final rule re: position limits

1. On Oct. 18, 2011, the Commodity Futures Trading Commission ("CFTC") adopted interim and final rules on positions limits applicable to options, futures contracts and swaps related to 28 agricultural, metal and energy contracts and "economically equivalent" contracts, and imposed stricter aggregation requirements under Part 151

B. Court vacates position limits

1. Key aspects of the CFTC final rule regarding position limits were scheduled to become effective on Oct. 12, 2012. On Sept. 28, 2012, the U.S. Federal District Court in Washington, D.C. (the "Court") vacated the position limit rulemaking

2. The primary issue was whether the statutory language of the Commodity Exchange Act, as amended by Dodd-Frank, required (1) that the CFTC find that the position limits were necessary or appropriate to prevent excessive speculation or (2) that the CFTC establish the position limits without regard to whether the limits were necessary or appropriate. The CFTC interpreted

the statute to mean that the CFTC was required to establish position limits without regard to whether they were necessary or appropriate

3. The Court found that the Commodity Exchange Act was ambiguous. According to the Court, in the circumstance where there is a plausible conflicting reading, the CFTC is obligated to acknowledge a conflicting reading prior to providing its interpretation. Since the CFTC did not acknowledge the ambiguity in the statute, the position limits were remanded

C. Aggregation issues

1. The Court did not determine whether the CFTC's aggregation standards promulgated in the final rule were arbitrary and capricious or in violation of the cost-benefit analysis required of CFTC rulemaking. The Court said it was not sure whether the aggregation rules are even ripe for a court determination. The Court remanded the entirety of the rules to the CFTC, leaving it to the CFTC to decide whether or not to amend the aggregation portion of the rule

2. The aggregation portion of the CFTC rule is likely to be relevant again. The original 151 aggregation limits required a person to aggregate all referenced contract positions in accounts for which the person controls or has a 10 percent or more ownership interest, in each case, directly or indirectly, subject to certain exemptions from aggregation

3. The CFTC modified its aggregation limits in a proposed rule published in May 2012. The CFTC proposed a three-tiered approach to aggregation. Entities with less than a 10 percent interest would not have to aggregate positions. Entities with an interest between 10 percent and 50 percent may be subject to relief from Part 151 if they satisfy certain conditions, such as (1) establishing a lack of knowledge of trading decisions, (2) establishing separate trading systems, (3) holding written procedures and (4) having separate employees. Entities with more than a 50 percent interest would have to aggregate positions

D. What this means for private fund clients

1. There are three courses of action for the CTFC: (i) statutory amendment of the CEA clarifying that position limits are mandatory; (ii) appealing and (iii) issuing another rule that would not be subject to challenge

III. Swap Documentation Requirements

A. On Aug. 27, 2012, the CFTC approved final rules regarding requirements for the (i) documentation of swap trading relationships between swap dealers ("SD") or major swap participants ("MSP") and their counterparties and (ii) timely and accurate confirmation of swaps. The rules will not apply retroactively and will require compliance only with respect to swaps entered into after the date on which compliance with the rules is required. For purposes of our panel discussions, we will focus on trades that SD/MSPs enter into with funds that are not MSPs

B. Swap trading relationship documentation

1. SDs and MSPs must follow written policies and procedures reasonably designed to ensure that the SD/MSP executes written swap trading relationship documentation with its counterparties. The ISDA Master Agreement is an example of such documentation

2. This required documentation must include all trade terms that govern the relationship. Terms include (i) payments obligations, (ii) netting of payments, (iii) events of default or other termination events, (iv) calculation and netting of obligations upon termination, (v) transfer of rights and obligations, (vi) governing law, (vii) valuation, (viii) dispute resolution and (ix) credit support arrangements

3. The CFTC noted in the rules release that the ISDA Master Agreement form does not "address the swap valuation requirements of §23.504(b)(4), the orderly liquidation upon termination provisions of §23.504(b)(5) or the clearing records required by §23.504(b)(6)."

C. Swap confirmations

1. With respect to swaps entered into by a SD/MSP with a fund, the SD/MSP must send an acknowledgment of the trade (which is just a written acknowledgment of the trade containing trade terms but is not mutually executed trade confirmation) as soon as technologically practicable, but in any event by the end of the first business day following the day of execution

2. In addition, SDs/MSPs must establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes a confirmation for each swap transaction that it enters into with a fund not later than the end of the second business day following the day of execution

3. Upon request by a prospective counterparty prior to execution of any swap, the SD/MSP must furnish to the prospective counterparty prior to execution, a draft acknowledgment specifying all terms of the swap transaction other than the applicable pricing and other relevant terms that are to be expressly agreed at execution

4. Compliance with the swap confirmation obligations is subject to a phase-in period depending on the type of counterparty the SD/MSP is facing and type of product

   (a) For interest rate and credit derivatives, SDs need to have executed confirmations (i) by the end of the second business day from the effective date of the Rule until Feb. 28, 2014 and (ii) by the end of the first business day, on and after March 1, 2014

   (b) For equity swaps, foreign exchange swaps or other commodity swaps, SDs need to have executed confirmations in place (i) by the end of the third business day following the day of execution for the period from the effective date of the Rule until Aug. 31, 2013, (ii) by the end of the second business day following the day of execution from Sept. 1, 2013, until Aug. 31, 2014 and (iii) by the end of the first business day following the day of execution on and after Sept. 1, 2014

D. Managers of private investment funds can expect that dealers will pressure funds to execute confirmations within that time period

E. SDs/MSPs cannot void or rescind a swap transaction based solely on the failure of the parties to confirm the transaction

F. Portfolio reconciliation and portfolio compression

1. SDs/MSPs must enter into a written agreement with private funds regarding portfolio reconciliation. The portfolio reconciliation may be performed bilaterally or by a third-party service provider. Private funds that have more than 100 swaps with a SD at any time during a calendar quarter must reconcile portfolios quarterly; otherwise, such reconciliation must be done annually. SDs/MSPs must have in place written procedures reasonably designed to resolved any discrepancies in the material terms or valuation of each swap identified as part of a portfolio reconciliation

2. SDs/MSPs must compress portfolios (that is, net offsetting positions in order to reduce risk) to the extent requested by their private fund clients

IV. ISDA Dodd-Frank Protocol

A. ISDA August 2012 Dodd-Frank Protocol

1. ISDA drafted an agreement that allows SDs and MSPs to comply with Dodd-Frank — the ISDA August 2012 Dodd-Frank Protocol (the “Protocol”). The Protocol amends existing documentation, including the ISDA Master Agreement or other specified agreements, through the submission of an agreement and questionnaire

2. The Protocol addresses final CFTC rules. Those rules pertain to business conduct standards for SDs and MSPs, large-trader reporting for physical commodity swaps, position limits for futures and swaps, real-time public reporting of swap transaction data and swap data recordkeeping

3. The Protocol includes, among other provisions, the obligation of private fund managers to provide SDs required representations, such as whether the private fund is an eligible contract participant or a specified entity. The compliance date for the Protocol is Dec. 31, 2012

4. There is expected to be additional addendums as provisions of Dodd-Frank are implemented

B. ISDA October 2012 Dodd-Frank Protocol

1. Addresses final CFTC rules regarding Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants and End-User Exception to the Clearing Requirement for Swaps

V. Reporting and Recordkeeping

A. Reporting

1. For swaps executed on a swap execution facility (a "SEF") or a derivatives contract market ("DCM"), the SEF or DCM must report swap creation data, including confirmation data and primary economic terms ("PET data"), "as soon as technologically practicable" after a swap's execution. In addition, a derivatives clearing organization must report all confirmation data "as soon as technologically practicable" after clearing. Confirmation data means all of the terms of a swap matched and agreed upon by the counterparties in confirming the swap. The PET data is attached to the final rules in asset class-specific tables and includes typical pricing information and unique swap identifiers, legal entity identifiers, an indication whether the counterparty is a SD or MSP, representing whether the non-reporting counterparty is a U.S. Person and whether the swap is a post-allocation swap, among many other criteria

2. With respect to off-facility swaps that are not executed on or pursuant to the rules of an SEF or a DCM, but are subject to mandatory clearing, the clearing house reports "as soon as technologically practicable" after a swap's execution

3. With respect to off-facility swaps not subject to mandatory clearing, parties report depending upon the status of the counterparties (e.g., dealers are obligated to report if they trade with private investment funds, U.S. Persons are obligated to report if they trade with non-U.S. Persons). Information must be reported "as soon as technologically practicable," but, depending upon the compliance date and the type of derivative and reporting counterparty, there is between 15 minutes and two days to report the information

4. Information must be reported to a Swap Data Repository ("SDR") or if no SDR is available, the Commission

5. Required swap continuation data, including life cycle event data and valuation data, must be reported pursuant to Rule 45.4

6. There are also real-time reporting obligations which mandates reporting of key economic terms for "publicly reportable swap transactions"

7. With regard to timing: Swap Counterparties that are not SDs or MSPs, but that are required to report a swap transaction that they execute with another non-SD/MSP, do not have to comply with the reporting requirements until April 10, 2013. This timing also applies to historical swaps

B. Recordkeeping

1. Funds must keep records relating to swaps throughout the existence of each swap and for five years following final termination or expiration of the swap

2. Records need to be readily accessible during the life of the swap and for two years thereafter and retrievable from storage within three business days during the remaining three years of the retention period

3. Funds must retain full and complete records, together with all pertinent data and memoranda

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5. Additional Materials

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Alert Update

New ESMA Guidance on European Short Selling Rules — Effective 1 November 2012

18 October 2012

On 10 October 2012 the European Securities and Markets Authority ("ESMA") published guidance in the form of Questions and Answers (the "Q&A")[1] on the implementation of the new EU Short Selling Regulation (the "Regulation").[2] The Regulation places new restrictions on short sales of securities traded in EU markets and EU sovereign debt, including credit default swaps ("CDS") that are referable to EU sovereign debt, as well as requiring certain private and public disclosures.[3] This *Alert* assesses some of the more significant guidance from the Q&A including (1) the scope of the jurisdiction of the Regulation and its application to non-EU markets, (2) the method of disclosure obligations, (3) the calculation of a net short position in a given market and (4) the differing disclosure requirements for management entities engaged in a variety of activities.

Status of the Q&A

Guidance from ESMA (including the Q&A) is not legally binding and is not EU law. ESMA is a supervisory authority established within the EU to work with regulators in EU countries to ensure coordination, monitoring and harmonisation of technical rules within the EU. However, because ESMA is the European Commission's securities and markets adviser, its guidance carries a great deal of weight and compliance with ESMA's guidance may be viewed as indicative of compliance with the underlying rules set forth in the Regulation.

Scope of the Regulation and Jurisdiction

The Q&A provides further perspective on the potential jurisdictional scope of the Regulation. (This *Alert* discusses the Regulation's stated scope and the ESMA guidance thereon, although the ultimate determination of the Regulation's reach will likely be subject to further debate.) In the Q&A, ESMA reiterates that the Regulation covers all securities admitted for trading on an EU trading venue (meaning an EU regulated market or an EU multilateral trading facility[4]), except where the principal trading venue for those securities is outside the EU — for which the Regulation specifies that there is an exemption from the disclosure requirements (see below, under "Disclosure Requirements"). The mere fact that a particular instrument is admitted for trading on an EU trading venue means that the requirements of the Regulation will apply to short sales of that instrument, irrespective of whether the instrument actually is traded on such venue. For EU sovereign debt, the defining requirement is that the financial instruments in question must be issued by (1) an EU country, (2) the EU itself, (3) the European Financial Stability Facility or (4) the European

[1] http://esma.europa.eu/news/ESMA-publishes-update-QA-Short-Selling-Regulation?t=326&o=home.

[2] EU Regulation No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:en:PDF).

[3] For information on the short selling restrictions, please see our 5 October 2012 *Alert*.

[4] A multilateral trading facility (or "MTF") is a trading venue that brings together buyers and sellers in a non-discretionary way, according to a defined set of rules resulting in trades — such as an investment bank's internal crossing systems where one client's order for a sell is matched with another client's order for a buy, or where the orders are filled directly off the bank's books.

Investment Bank,[5] and any short sales of such EU sovereign debt instruments or CDS referable to such sovereign debt will be subject to the Regulation's requirements (i.e., disclosure obligations, locate rule requirement, etc.).

The Q&A indicates that the location of a person placing a trade is not relevant; irrespective of whether the trade is placed by a person in an office outside the EU, the Regulation will apply based on the above factors.[6] As a result, persons anywhere in the world are required to comply with the Regulation.[7]

The restriction on uncovered short sales relates only to shares admitted to trading on a trading venue. That means that short sales in instruments such as subscription rights and convertible bonds (e.g., performed as part of a capital increase) do not fall within the scope of the Regulation.[8] However, claims to as-yet-unissued shares (subscription rights, convertible bonds) may cover a short sale, provided that the availability of the new shares for settlement by the arrangement is ensured when settlement is due (e.g., the rights or convertible bonds can be converted into shares that would be available in time for ensuring the settlement).[9]

The prohibition on uncovered short sales of EU sovereign debt instruments covers all debt instruments issued by an EU sovereign issuer irrespective of the currency in which they are issued.[10] Accordingly, if an EU country were to issue US-dollar denominated bonds, any person shorting the bond must cover that short sale.[11]

Disclosure Requirements

Once every two years, ESMA will publish on its website a list of exempted shares that are not subject to the Regulation's notification and disclosure requirements because ESMA has already determined that for the preceding two years the principal trading venue for those shares was a venue outside the EU; the first such list has already been published[12] and will be updated by ESMA in two years' time. Any EU security not mentioned in that list is subject to the requirements of the Regulation.[13] With respect to EU sovereign debt and CDS referable to EU sovereign debt, ESMA has also recently published a list[14] of the applicable disclosure thresholds applicable to each EU sovereign debt issuer, so that anyone short selling EU sovereign debt or entering into CDS referable to EU sovereign debt can easily confirm whether they need to make a disclosure at the 0.1 percent threshold (with incremental further disclosures at each 0.05 percent thereafter) or at the 0.5 percent threshold (with incremental further disclosures at each 0.25 percent thereafter).

For the purposes of calculating and, if necessary, reporting, the net short position held in connection with EU securities, ESMA has clarified that positions should not be rounded, but truncated to two decimal points. (i.e., 0.3199 percent becomes 0.31 percent and not 0.32 percent).[15] Disclosure is required only when a person has a net short position that meets or exceeds the initial 0.2 percent threshold and each incremental further threshold at 0.1 percent thereafter (whether upwards or downwards). No new disclosure is required if a position changes over time in between thresholds, in which case any initial threshold filing made will suffice and does not need to be updated. ESMA gives the example in the Q&A of a position of 0.3 percent net short having already been reported, which might fluctuate on a daily basis up to 0.312 percent or 0.3989 percent –

[5] Q&A 1a.

[6] Q&A 1b.

[7] Q&A 1c.

[8] Q&A 7b.

[9] Q&A 7c.

[10] Although relatively uncommon, some EU countries issue sovereign debt instruments denominated in currencies other than their own national currency — particularly where they are seeking to access alternative markets and leverage new investor bases.

[11] Q&A 7d.

[12] http://www.esma.europa.eu/page/List-exempted-shares.

[13] A list of *all* shares admitted to trading on an EEA regulated market which identifies the relevant regulator for each share is also available at: http://mifiddatabase.esma.europa.eu/.

[14] http://www.esma.europa.eu/page/Net-short-position-notification-thresholds-sovereign-issuers.

[15] Q&A 2f.

meaning that the 0.4 percent threshold has not been reached and no further upward disclosure would be required, and equally, the position never fell below 0.3 percent, meaning that no downward disclosure would be required.[16]

Content and Timing of Disclosure
The specific content required for disclosures relating to disclosable net short positions in EU securities was set forth in a Delegated Regulation.[17] At present no centralised list of disclosure mechanisms for each EU regulator has been made available for the disclosure of net short positions. ESMA will be publishing such a list on its website[18] before 1 November 2012 (as this is a requirement imposed on ESMA by the Regulation).[19]

Many EU countries already have existing reporting and disclosure rules for persons with net short positions in certain securities (particularly EU financial sector issuers). Even though holders of net short positions may already have made a disclosure under national disclosure rules, any holders of reportable net short positions held at 3:30 pm (local time for the relevant EU market) will have to make a new disclosure under the Regulation, even if it is duplicative. The disclosure made on 2 November 2012 to report on the position as at 3:30 pm (local time for the relevant EU market) on 1 November 2012 will replace the previous disclosure made under previous national disclosure rules. ESMA has stated that the "position date" for the reporting of such disclosures should be referenced as 1 November 2012, even if the net short position has in fact been in place for several weeks or months.[20]

If daily disclosures of reportable net short positions are received by the applicable EU regulator after 3:30 pm local time, the regulator will publish the data on the next trading day.[21] However, regulators may choose to delay the publication of particular net short positions where they consider that the disclosure needs to be authenticated.[22]

Late disclosures will constitute a breach of the Regulation and may be subject to the investigation and enforcement policies of the relevant regulator.[23] There are no safe-harbour provisions and a breach of the Regulation could potentially be viewed as a strict liability offence, although the repercussions of a breach may vary from regulator to regulator as the penalties for breach of the Regulation have not been harmonised at an EU level; the Regulation merely requires that penalties and measures for breaches must be "effective, proportionate and dissuasive".[24] The Regulation requires that in advance of 1 November 2012, ESMA must provide a list on its website[25] describing on a country-by-country basis the penalties and administrative measures in each EU country which will be applicable to any breach of the Regulation. In the UK, by way of example, the Financial Services Authority has stated[26] that it will apply its current penalty regime — meaning that it could (1) publish a public censure (stating that Person X has breached the short selling rules and has been reprimanded), (2) impose a financial penalty or (3) if the person is a UK FSA authorised firm or an approved person, it could place a temporary or permanent prohibition on that firm or person prohibiting them from conducting regulated activities in/ from the UK.

Calculating Net Short Position — Aggregation of Holdings and Other Issues for Investment Managers
The Q&A provides additional information and guidance on which entity or entities have a reporting obligation when there are several entities in a group or within a fund management structure which have a net short

[16] Q&A 2f.

[17] http://ec.europa.eu/internal_market/securities/docs/short_selling/20120629-regulatory_en.pdf.

[18] http://www.esma.europa.eu/page/Short-selling.

[19] Article 9(4) of the Regulation.

[20] Q&A 2c.

[21] Q&A 6a.

[22] Q&A 6a.

[23] Q&A 6a.

[24] Article 41 of the Regulation.

[25] See footnote 18.

[26] See sections 2.22 – 2.25 of the FSA consultation paper at http://www.fsa.gov.uk/static/pubs/cp/cp12-21.pdf.

position in a particular EU issuer and when these positions also have to be aggregated and reported. In addition, annexes to the Q&A explain the following scenarios in diagram format:

Entity by Entity Assessment: The Regulation requires that any person (whether a natural person or a legal person such as a company, fund or managed account) that has a net short position in an EU issuer which has reached or exceeded the 0.2 percent disclosure threshold (or the subsequent 0.1 percent thresholds thereafter) is required to make a disclosure to the relevant regulator.

Discretionary Manager Assessment: The Q&A indicates that where a manager has discretionary management authority for several funds or managed accounts, the manager must:

(i) Assess for each fund and managed account whether any of them has a disclosure obligation, and must make the applicable disclosures in the relevant fund's or managed account's name(s)[27] and

(ii) Aggregate those funds and managed accounts that each have a net short position (even if those positions individually are beneath the initial 0.2 percent disclosure threshold) and report to the relevant regulator the total aggregated net short position in the name of the manager (assuming the aggregate position reaches or exceeds the initial 0.2 percent disclosure threshold).[28] Funds and managed accounts with a net long position in the relevant issuer are discounted for these purposes.

For umbrella funds, the calculation should take place at the level of the respective sub-funds and for master-feeder funds, the calculation takes place at the master fund level.

Discretionary Manager Conducting Additional Activities: Where a manager performs both discretionary management activities for funds and managed account clients and also performs non-management activities (including proprietary trading), the manager will be required to conduct two different and separate net short position calculations, one for each activity. For the management activities, the calculations and reporting should be conducted as set forth above (in the paragraphs numbered (i) and (ii)). For non-management activities, the manager should calculate the net short position in each particular issuer, excluding the management activities, and disclose when a relevant threshold is reached. As a result, a manager may be required to report two net short positions with respect to the same issuer: one for the management activities and the other for the non-management activities.[29]

Groups of Managers: The reporting of net short positions in any EU issuer for groups[30] of fund managers is to be made at the group level.[31] However, the Q&A clarifies that it is only the net short positions of the entities within the group that have a net short position that should be aggregated; those entities within the group that have a long position are discounted for the purposes of reporting whether the group has a disclosure obligation.[32] As a result, while a manager will be required to make a disclosure on behalf of any funds or managed accounts for which it has discretionary management authority (assuming they reach or exceed a notification threshold), where a manager is a part of a group of managers under a common parent undertaking, the manager will not be required to report its own net short position in a particular issuer unless the aggregated net short position at the group level reaches or exceeds a notification threshold.[33]

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[27] In ESMA's terminology "pursuing the same investment strategy" means that a particular fund or portfolio is either long the relevant issuer or short that issuer. Q&A 5a.

[28] Q&A 5a and 5e.

[29] Q&A 5b.

[30] "Group" for these purposes means any undertaking in which that undertaking's parent undertaking has (1) a majority of voting rights, (2) the right to appoint or remove a majority of the members of the subsidiary undertaking's administrative, management or supervisory body and is at the same time a shareholder in, or member of, the subsidiary undertaking in question, (3) control over a majority of the shareholders' or members' voting rights pursuant to an agreement entered into with other shareholders or members of the subsidiary undertaking in questions, or (4) the power to exercise, or actually exercises, dominant influence or control. The ultimate parent undertaking in any such "group" may be a single natural or legal person. (Article 2(a) of the Delegated Regulation": http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:390:0038:0038:EN:PDF).

[31] Q&A 5f.

[32] Q&A 5e.

[33] Q&A 5f & 5h.

The Q&A is explicitly clear that where a manager within a group performs both discretionary management activities and non-management activities it is required, with respect to any particular issuer, to calculate separately the positions for each fund or managed account that it advises as well as the positions held by group entities and report, where relevant, the net short position in the particular issuer resulting from its discretionary management activities from any net short position resulting from its non-management activities (which would be reported at the group level as noted above).[34] A discretionary manager is not required to aggregate net short positions held by group entities (held as a result of non-management activities) with net short positions held by funds or managed accounts that the manager advises.

ESMA's guidance is also clear that short sales entered into by one entity within a group cannot be covered by having another entity in the group borrow or agree to borrow the shares or have that other entity within the same group obtain a locate.[35]

Valuation of Positions

The Q&A provides further information on the treatment of certain types of securities for purposes of determining an entity's position and whether it is long or short and whether a disclosable net short position is held.

ETFs, Baskets and Indices: Disclosures are to be calculated according to issuer — whether held directly or indirectly. ESMA has clarified that positions held through indices must be included in the net short position calculation — which means that the position holder must calculate its interest in the relevant issuer in accordance with that issuer's weighting in the index.[36] Shares in ETFs should also be taken into account.[37] When looking through basket securities and ETFs, holders will not necessarily have access to the exact data on the underlying positions and instead should use the most recently available public information in order to calculate, on a reasonable efforts basis, their interest in each issuer held through the basket or ETF.[38]

Dividend and Bonus Shares: Dividends in the form of shares that are issued on repo'd securities should not be included by the borrower of the shares in calculating its long position.[39] Shares received as part of a bonus share issue or share dividend distribution, however, do count towards a long position.[40]

Unissued Shares: Instruments that give claim to shares not yet issued (e.g., subscription rights, convertible bonds) should not be taken into account as long positions.[41] Interest rate swaps likewise may not be set off against sovereign debt in calculating the net short position.[42] It is possible, however, to cover a short sale by entering into a repo contract afterwards with the same (or earlier, but not later) settlement date as the short sale.[43] A sovereign CDS position may likewise be used to hedge a risk related to another CDS position referring to the same sovereign debt.[44]

EU Sovereign Debt: In the Q&A, ESMA sets forth principles and an equation for calculating the value of net short positions on EU sovereign debt using a "nominal value duration adjusted" methodology which assesses the value of the EU sovereign debt (and hence the figure for the reportable net short position) based, in part, on the nominal value and the amount of time before the sovereign debt's maturity date.[45] If an increase or

[34] Q&A 5g.

[35] Q&A 7a.

[36] Q&A 5d.

[37] Q&A 3a.

[38] Q&A 3g.

[39] Q&A 3d.

[40] Q&A 3e.

[41] Q&A 3c.

[42] Q&A 3f.

[43] Q&A 7e.

[44] Q&A 7i.

[45] Q&A 4a and 4b

decrease in the particular duration-adjusted nominal value causes an investor's position to cross a threshold, even without the investor having taken any investment decision, and without changes in the nominal position, such investor would still be required to make a disclosure to the relevant regulator.

More Information

For more information on the issues set forth in this *Alert*, please refer to the Q&A,[46] one of the authors or your attorney at Schulte Roth & Zabel.

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[46] A link to the Q&A is set forth at Footnote 1.

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Alert

New European Rules on Short Selling — Effective 1 November 2012

5 October 2012

The EU *Regulation No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps* (the "Regulation")[1] and the subsidiary legislation made under it take effect in all 27 countries of the EU on 1 November 2012 and will replace all existing rules on short selling activities in EU countries.

With respect to almost all securities listed on exchanges in the EU,[2] the Regulation will require disclosure, both to the regulator of the relevant EU country on whose market(s) the particular securities are listed and (in certain circumstances) to the public, of any net short positions[3] in excess of 0.2 percent held by any persons, anywhere in the world. With regard to short positions in EU sovereign debt or credit default swaps ("CDS")[4] referable to EU sovereign debt, a private disclosure will also be required to be made to the regulator of the EU country whose debt forms the subject of the CDS, although for CDS there is no requirement for disclosure to the public.

The Regulation also introduces an EU "locate rule" which requires that persons short selling EU securities or EU sovereign debt must have covered their short position(s) and, unless a very narrow exemption is applicable (see below), CDS positions referable to EU sovereign debt must also be covered. Existing uncovered positions which cannot be covered before 1 November 2012 may need to be unwound to be in compliance with the Regulation.

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:EN:PDF.

[2] See "Territorial Effect" below for more information on the limited exception.

[3] Article 2(1)(b) of the Regulation defines a "short sale" as any sale of the share or debt instrument which the seller does not "own" at the time of entering into the agreement to sell, including such a sale where at the time of entering into the agreement to sell, the seller has borrowed or agreed to borrow the share or debt instrument for delivery at settlement, not including: (i) a sale by either party under a repurchase agreement where one party has agreed to sell the other a security at a specified price with a commitment from the other party to sell the security back at a later date at another specified price; (ii) a transfer of securities under a securities lending agreement; or (iii) entry into a futures contract or other derivative contract where it is agreed to sell securities at a specified price at a future date. "Ownership" means legal or beneficial ownership in accordance with the civil law or securities law applicable in the jurisdiction of the sale. The definition of a short sale excludes the selling of financial instruments: (a) transferred under a securities lending or repurchase (repo) agreement, if the securities will either be returned or the transferor recalls them so that settlement can be effected when it is due, (b) by a person who has purchased the instrument prior to the sale but has not taken delivery of it at the time of the sale, and (c) by a person who has exercised an option or similar claim on them, if the securities will be delivered so that settlement can be effected when due (Article 3 of the Delegated Regulation).

[4] Article 2(1)(c) of the Regulation defines a "credit default swap" as a derivative contract in which one party pays a fee to another party in return for a payment or other benefit in the case of a credit event relating to a reference entity and of any other default, relating to that derivative contract, which has a similar economic effect.

Background
For more information regarding the background to the Regulation please refer to our 21 October 2010 *Alert*.[5]

EU Short-Selling Rules
The key provisions of the Regulation and its delegated measures are:

Instruments covered by the rules. The Regulation covers shares and other financial instruments admitted to trading on an EU market[6] ("Relevant Financial Instruments") and derivatives relating to such Relevant Financial Instruments (even where the Relevant Financial Instruments or derivatives are traded outside an EU market), as well as EU sovereign debt and CDS referencing EU sovereign debt.[7] The Regulation seeks to provide for a proportionate response to the risks that short selling of different instruments may represent. CDS referable to EU sovereign debt are covered, since buying CDS without having a long position in underlying sovereign debt may be considered to be, economically speaking, equivalent to taking a short position on the underlying debt instrument.

Territorial effect. The Regulation and the disclosure rules will apply to any person (whether a natural person or a legal person) anywhere in the world who has a net short position in Relevant Financial Instruments traded on an EU market, or a short position in EU sovereign debt or who effectively shorts EU sovereign debt using CDS. However, Relevant Financial Instruments for which the "principal trading venue" is outside the EU are excluded from the disclosure requirements.[8]

Disclosure of net short positions. The Regulation requires that disclosures are made by persons with significant net short positions relating to Relevant Financial Instruments and by persons with significant net short positions in EU sovereign debt (including positions in CDS referencing EU sovereign debt), as follows:

- For companies that have Relevant Financial Instruments admitted to trading on an EU market, the Regulation provides for a two-tier disclosure model for significant net short positions in Relevant Financial Instruments:
    1. At a threshold of 0.2 percent (of the value of the issued share capital of the company concerned), 0.3 percent and 0.4 percent, disclosure* must be made privately to the regulator;[9] and
    2. At 0.5 percent and each 0.1 percent above that, disclosure* must be made both to the regulator and publicly.[10]
- For EU sovereign debt, the Regulation provides that disclosure* of net short positions in EU sovereign debt and CDS positions referable to EU sovereign debt must be made privately to the relevant EU regulator at:
    1. 0.1 percent, where the total amount of the outstanding issued sovereign debt is less than Euros 500 billion, with incremental thresholds every 0.05 percent (i.e., at 0.15 percent, 0.20 percent, 0.25 percent, etc.); and
    2. 0.5 percent, where the total amount of the outstanding issued sovereign debt is Euros 500 billion or greater (or where there is a liquid futures market for the particular sovereign debt),

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[5] http://www.srz.com/102110_proposed_new_pan_european_rules_on_short_selling/.

[6] An EU regulated market or an EU multilateral trading facility.

[7] Sovereign debt instruments issued by any EU member state, the EU itself, the European Financial Stability Facility and the European Investment Bank are covered by the Regulation.

[8] Article 16 of the Regulation specifies that those Relevant Financial Instruments that are admitted to trading in the EU but for which the principal trading venue is outside the EU are exempt from the disclosure requirements. The principal trading venue will be that which has the largest volume of trading over the previous 24 months. A list of the exempted instruments is available online at: http://www.esma.europa.eu/page/List-exempted-shares.

[9] Article 5 of the Regulation.

[10] Article 6 of the Regulation.

with incremental thresholds every 0.25 percent (i.e., at 0.75 percent, 1.00 percent, 1.25 percent, etc.).[11]

- For net short positions in Relevant Financial Instruments and short positions and CDS positions relating to EU sovereign debt issuers, the disclosures* must be made when position size is either increasing or decreasing through the relevant thresholds.

* *Please see "Method of notification and disclosure" for more information regarding the mechanics of making the disclosures.*

Calculating a net short position. The calculation of a short or long position should take into account *any* form of economic interest which a person has in relation to the issued share capital of a company or the issued sovereign debt of an EU country. Holdings and short positions in different share classes must be consolidated; the disclosable net short position thresholds relate to the issuer as a whole, not to any specific class of relevant Financial Instruments. Calculations should take into account any interest obtained directly or indirectly through the use of derivatives (including options, futures, contracts for differences and spread bets) relating to Relevant Financial Instruments or sovereign debt. No distinction is drawn between short positions which are hedges and those that are investment positions. In the case of positions relating to sovereign debt, calculations should also take into account credit default swaps relating to sovereign debt issuers. The method for calculating a net short position has been clarified by the European Securities and Markets Authority ("ESMA") in a subordinate regulation under the Regulation itself (known in the EU as the "Delegated Regulation")[12] as follows:

- *Relevant Financial Instruments.* With regard to calculating a long or a short position, the Delegated Regulation states that the holding of a Relevant Financial Instruments through an indirect interest in a basket of Relevant Financial Instruments which contains the relevant share must be taken into account to the extent that the share is represented in the basket; exposure through a derivative instrument which confers a financial advantage/disadvantage in the event of an increase/decrease in the price of the relevant share must also be taken into account. Also, the Delegated Regulation confirms that it is irrelevant whether cash settlement or physical delivery of the underlying assets have been agreed when determining net short positions — the position must still be included in a firm's calculations.[13]
- *Sovereign Debt*. Under the Regulation, a long position in debt instruments of an EU sovereign issuer must be taken into account when calculating a net short position if the pricing of such debt instruments is "highly correlated" (see below) to the pricing of the sovereign debt. The Delegated Regulation clarifies that "pricing" means the yield, but where there is no yield or where this would be an inappropriate comparator, "pricing" means the price. Also, as with Relevant Financial Instruments, holding a position in EU sovereign debt through a long position in a basket of debt instruments will be taken into account as a long position to the extent that the sovereign debt is represented in the basket. In addition, a debt instrument and an issued sovereign debt are considered highly correlated where the correlation is at 80 percent between the pricing of the debt instrument of another sovereign issuer and the pricing of the given sovereign debt for the relevant period. However, where a position ceases to meet the high correlation test over a 12-month period, the sovereign debt of the issuer can no longer be taken into account when calculating a long position. Nevertheless, temporary fluctuations are permitted, provided the correlation remains at least 60 percent and dips below the 80 percent threshold standard for no longer than three months.[14]
- For both Relevant Financial Instruments and sovereign debt, a delta adjusted method must be used when calculating whether the holder has a net short position.[15] For Relevant Financial Instruments, the calculation must take into account transactions in all financial instruments conferring an advantage in the event of a change in price or value, whether traded on or outside a trading venue,

[11] Article 21 of the Delegated Regulation.

[12] http://ec.europa.eu/internal_market/securities/docs/short_selling/20120705-regulation_en.pdf.

[13] Articles 5, 6, 7 & 10 of the Delegated Regulation.

[14] Articles 8, 9 & 11 of the Delegated Regulation.

[15] Set forth in Annex II of the Delegated Regulation.

and for sovereign debt positions must be calculated for every sovereign issuer in which the person holds a short position.

- The Delegated Regulation sets forth an aggregation procedure in relation to funds or managed accounts and in relation to positions held by different entities within a corporate group. For fund managers, net short positions must first be calculated for each individual fund or managed account under management. However, individual net short positions for funds or managed accounts pursuing the same investment strategy with respect to a particular issuer must then be aggregated when determining whether or not a disclosable net short position is held. Where a fund manager delegates management to a third party, that delegate must calculate and report any disclosable net short positions in relation to the delegated fund or portfolio; the fund manager will not be required to aggregate the delegated fund's or portfolio's positions with the net short positions for those funds or portfolios for which the fund manager is required to report net short positions. Where various entities within a corporate group have net short positions in Relevant Financial Instruments or EU sovereign debt, the Delegated Regulation requires that each entity within the group must calculate and report its net short positions separately (assuming the aggregate net short position exceeds the disclosure threshold). In addition, all positions are required to be aggregated and reported at group level.[16]

As the foregoing makes clear, calculating whether or not a disclosable net short position exists is likely to present an operational challenge for many market participants, all of whom will need to ensure that they have systems for monitoring EU sovereign debt positions and any positions in Relevant Financial Instruments in order to be able to comply with the Regulation's requirements.

Content of disclosures. The relevant disclosures must cover, at a minimum, the identity of the person who has the relevant disclosable net short position, the size of the position, the issuer in relation to which the position is held and the date on which the position was created, changed or ceased to be held.[17] A subordinate regulation that sets forth the content requirements for disclosures[18] expands on these principles and prescribes a format that all short selling disclosures and CDS disclosures must follow (so that all EU countries have a harmonised form of disclosure). The information must include:

- The name of the fund (i.e., the person holding the net short position);
- The BIC code, if the fund has one;
- Country (where the fund is established);
- The fund's registered address;
- The name, address and contact details for the investment manager/investment adviser that is reporting on the fund's behalf;
- The reporting date;
- Name of the issuer (including ISIN code);
- The date that the applicable net short position was reached;
- The net short position after crossing the relevant threshold (expressed as the number of shares and the percentage of the issued share capital); and
- The date of any previous notification made by the investment adviser on the fund's behalf.

Timing of disclosure. Disclosure must be made by not later than 3.30 pm (local time for the relevant market) on the next trading day after which the person first has the disclosable position or passes through the relevant incremental threshold(s).[19]

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[16] Articles 12 & 13 of the Delegated Regulation.

[17] Article 9(1) of the Regulation.

[18] http://ec.europa.eu/internal_market/securities/docs/short_selling/20120629-regulatory_en.pdf.

[19] Article 9(2) of the Regulation.

Method of notification and disclosure. The notification of information to the relevant regulator will need to be made in accordance with the prescribed requirements of each EU regulator. It is generally believed that regulators will either implement new online disclosure systems or will require that disclosures are made using the electronic notification systems currently used for the notification of substantial shareholdings in listed companies. Before 1 November 2012, ESMA will publish a list of electronic links to central websites operated or supervised by EU regulators where the public disclosure of net short positions may be posted. The links will appear on ESMA's short selling website.[20]

Penalties for failure to notify regulator. The Regulation requires that EU countries must establish rules on penalties for those persons who fail to comply with the disclosure rules. The Regulation gives ESMA the power to issue harmonising guidelines, if necessary, to ensure that a consistent approach to penalties is taken by regulators across the EU.[21] At the time of writing this *Alert*, ESMA had not used this power and therefore the penalty for failing to comply with the short selling disclosure rules will be those enforced by each EU regulator. ESMA will publish a list of each EU country's short selling penalties on its short selling website before 1 November 2012.[22]

Prohibition of uncovered shorts and new EU "locate" rule. Investment advisers entering into short sales of Relevant Financial Instruments, or short positions or CDS positions relating to EU sovereign debt issuers, must at the time the short sale is entered into have either borrowed the instruments or have another enforceable claim under contract or property law to be transferred ownership of the instruments, entered into an agreement to borrow the instruments or made other arrangements which ensure that they can be borrowed so that settlement can be effected when it is due.[23] The requirement permits legitimate arrangements that are currently used to enter into covered short selling and which ensure that securities will be available for settlement.[24] The prohibition on uncovered short sales also extends to CDS on EU sovereign debt and the Regulation contains a "locate" rule requirement for EU sovereign debt.[25]

For Relevant Financial Instruments, a further delegated regulation under the Regulation (known as the "Implementing Regulation")[26] sets forth two broad types of "locate" arrangements, as follows:

- The standard "locate" arrangement must consist of:
  - A confirmation provided by a third party prior to the short sale that it considers that it can make the shares available for settlement and indicating a period for which the shares are located (a "locate" confirmation); and
  - A confirmation that the third party has at least put on hold the requested number of shares (a "put on hold" confirmation).
- The standard same day "locate" and "easy to borrow or purchase" arrangements must include a "locate" confirmation from a third party (as above) and a confirmation that the share is easy to borrow or purchase or, in the absence of such confirmation, a "put on hold" confirmation.[27]

[20] http://www.esma.europa.eu/page/Short-selling.

[21] Article 41 of the Regulation.

[22] Please see footnote 20.

[23] Article 12 of the Regulation.

[24] These arrangements include futures, options and repurchase agreements.

[25] Article 13 of the Regulation.

[26] http://ec.europa.eu/internal_market/securities/docs/short_selling/20120629-technical-standards_en.pdf.

[27] Articles 5 & 6 of the Implementing Regulation.

For sovereign debt, the Delegated Regulation sets forth four different types of locate arrangements:

- A “standard” locate, which is a confirmation from a third party that it considers that it can make the sovereign debt available for settlement in due time in the amount requested taking into account market conditions and indicating the period for which the sovereign debt is located;
- A “time limited” confirmation, which is similar to the “same day locate” for Relevant Financial Instruments;
- An “unconditional repo confirmation”, which relies upon the third party’s participation in a central bank or other repo arrangement that provides unconditional access to the sovereign debt in question; and
- An “easy to purchase” confirmation, which is similar to the “easy to borrow or purchase” confirmation for Relevant Financial Instruments.[28]

The Implementing Regulation specifies[29] the types of third parties from whom the “locate” confirmations may be obtained. They include:

(1) Counterparties within the EU

- Regulated investment firms or other regulated financial institutions which participate in the “management of borrowing” or purchasing of relevant shares or sovereign debt;
- Central counterparties;
- Securities settlement systems;
- Central banks; or
- National debt management entities (in relation to sovereign debt only).

(2) Where the third parties are non-EU entities, the Implementing Regulation requires that they must be subject to supervision by a regulatory authority with appropriate cooperation arrangements with the relevant EU regulator.

“Hedging” exemption for EU sovereign debt CDS. Even though the Delegated Regulation sets forth various options to locate arrangements in connection with the relevant sovereign debt instruments which must be in place at the time that the CDS is entered into, the Regulation does contain a very limited exception to the locate rule for CDS relating to EU sovereign debt. The Regulation notes that a CDS position is not deemed to be uncovered if it serves to hedge against (a) the risk of default of the issuer where the person has a long position in the sovereign debt of that issuer to which the sovereign CDS relates or (b) the risk of a decline of the value of the sovereign debt where the person holds assets or is subject to liabilities, including but not limited to financial contracts, a portfolio of assets or financial obligations the value of which is highly correlated to the value of the sovereign debt.[30]

In the Delegated Regulation[31] clarification is provided as to when a sovereign CDS transaction is considered to be hedging against a default risk or the risk of a decline in the value of the sovereign debt — meaning that it is not an uncovered CDS position. To qualify, a sovereign CDS position must meet the following conditions:

- It must serve to hedge against either or both risk of default and risk of a decline in value;
- There must be a consistent significant correlation between the value of the asset or liability being hedged and the value of the sovereign debt referenced;

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[28] Article 7 of the Implementing Regulation.

[29] Article 8 of the Implementing Regulation.

[30] Article 4(1) of the Regulation.

[31] Article 14 of the Delegated Regulation.

- A sovereign CDS position referencing an EU country may be used to hedge any assets or liabilities meeting the correlation test above — provided that the obligor of (or counterparty to) the asset or liability is located in the same EU country as the country referenced for the CDS; and
- The CDS position must be proportionate to the risks it is hedging.[32]

On the basis of the prohibition on uncovered CDS, all CDS referable to EU sovereign debt will fall into one of three classes and position holders should be aware that they may need to take action to avoid the CDS being an unlawful transaction.

1. Those entered into before 25 March 2012: These may be held until maturity (whenever that may be), even if they would result in an uncovered position after 1 November 2012.
2. Those entered into between 25 March and 1 November 2012: These are still permitted, but have to be unwound before 1 November 2012, unless they fall within the hedging exemption above.
3. Those entered into after 1 November 2012: Any new CDS referable to EU sovereign debt will not be permitted, unless it falls within the hedging exemption above.

New powers for EU regulators. The Regulation provides[33] that in the case of "adverse developments which constitute a serious threat to financial stability or to market confidence" in one or more EU countries,[34] EU regulators may require persons to disclose their short positions in any EU issuer, or may prohibit or restrict short selling activities that would otherwise be legitimate or pose minimal risks. In addition, in "exceptional circumstances" (where there are adverse events or developments which constitute a serious threat to financial stability or to market confidence) EU regulators will have the power to prohibit or restrict CDS referable to that country's sovereign debt. The power of intervention for regulators only contemplates temporary action/ bans for up to three months, with possible extensions of up to three months at a time, but this must be fully justified as well as being notified to and confirmed by ESMA.[35]

In highly exceptional circumstances, where two conditions are fulfilled, ESMA may itself take action and impose a pan-European ban on short selling. These conditions are: (1) there is a threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the EU (and there are cross-border implications) and (2) measures have not been taken by EU regulators, or such measures are not deemed to be sufficient, to address the threat.[36]

Effective date. The new EU rules on short selling come into effect in each of the 27 EU countries on 1 November 2012.

Authored by Neil Robson, Christopher Hilditch and Daniel F. Hunter.

If you have any questions concerning this *Alert*, please contact one of the authors or your attorney at Schulte Roth & Zabel.

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[32] Limited over-provisioning shall be permissible where the relevant party can justify (to the relevant regulator) why an exact match was not possible and can justify that a larger CDS position was necessary to match a measure of risk associated with the reference portfolio taking into account (1) the size of the nominal position, (2) the sensitivity ratio of the exposures to the obligations of the sovereign which are which scope of the CDS, and (3) whether the hedging strategy being used is static or dynamic. (Article 19 of the Delegated Regulation).

[33] Articles 18 to 26 of the Regulation.

[34] Article 24 of the Delegated Regulation includes (1) serious financial, monetary or budgetary problems; (2) a rating action or default by a Member State or a bank and other financial institutions deemed important to the global financial system; (3) substantial selling pressures or unusual volatility causing significant downward spirals in any financial instrument related to any banks or other financial institutions deemed important to the global financial system; (4) any relevant damage to the physical structures of important financial issuers, market infrastructures, clearing and settlement systems, and supervisors which may adversely affect markets where such damage results from a natural disaster or terrorist attack; and/ or (5) any relevant disruption to any payment system or settlement process.

[35] Articles 24 and 26 of the Regulation.

[36] Article 28 of the Regulation.

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Alert

Update for Swap Counterparties: ISDA's Dodd-Frank Protocol – Addition of Addendum I

October 5, 2012

ISDA has included an Addendum I (the "Addendum") to the ISDA August 2012 Dodd-Frank Protocol Questionnaire ("Questionnaire"), which provides provisions addressing changes to certain "eligible contract participant" categories that will become effective on Dec. 31, 2012. The Addendum is relevant to any OTC Derivative Counterparties that are "commodity pools" and who (a) rely upon the "Large Entity" or "Hedging Entity" categories through Dec. 31, 2012 or (b) who wish to engage in certain FX transactions.

Any OTC Derivative Counterparties who have already submitted their Questionnaires are permitted to submit this Addendum to update their representations. Parties who have not completed their Questionnaires may complete this Addendum along with the Questionnaire. OTC Derivative Counterparties are advised to review the annotated Questionnaire for instructions on how to complete both the Questionnaire and Addendum.

To review the updated Questionnaire and Addendum, please visit the ISDA website at http://www.ISDA.org.

If you have any questions, please contact *Paul N. Watterson, Jr*., *Craig Stein*, *Nanette Aguirre* or your attorney at Schulte Roth & Zabel.

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ISDA Publishes Tri-party IA Notices for the Custody of Collateral for OTC Swap Counterparties

September 4, 2012

The International Swaps and Derivatives Association (ISDA) recently published Tri-party IA Notices as part of its ongoing roll-out of documentation developed in response to the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Tri-party IA Notices are supplemental documentation designed to expedite the negotiation of control-agreement documents for establishing third party custodian relationships for over-the-counter derivatives contracts and swap arrangements.

Swap counterparties that are neither swap dealers nor major swap participants (generally, the "buy-side") may elect to custody posted Independent Amounts with a third party custodian, instead of with their swap dealer counterparties. In the event the swap dealer counterparty were to become a debtor under the Bankruptcy Code, the other party would be an unsecured creditor with respect to any collateral that it may have posted to the swap dealer counterparty under the ISDA Master Agreement and related Credit Support Annex.[1] Using a third party custodian to hold any collateral posted with a swap dealer may allow a buy-side counterparty to obtain the return of its collateral upon the designation of an Early Termination Event or after the occurrence of a Termination Event or Event of Default, including a Bankruptcy Event of Default. Other insolvency proceeding regimes have similar concepts.

The buy-side has experienced increased costs and delays as they attempt to negotiate the documentation necessary to set-up a third party custodian relationship. The agreements generally include an account control agreement, a fee letter, a sample notice of exclusive control and a termination notice. In an attempt to expedite the negotiation of these agreements, ISDA published the Tri-party IA Notices which are the Notice of Exclusive Control, Pledgor Access Notice (usually referred to as the Notice of Termination) and the Conflicting Instructions Provision. The ISDA Tri-party IA Notices do not provide a template account control agreement; ISDA only provides the supplement documentation which will reference the account control agreement which will be supplied by the third party custodian.

The Notice of Exclusive Control and Pledgor Access Notice are very similar, except that the Secured Party (the swap dealer) sends the Notice of Exclusive Control to the third party custodian (the "Securities Intermediary") following an Event of Default or Specified Condition where the buy-side counterparty is the

[1] Upon a bankruptcy of an entity, the "automatic stay" generally would preclude creditors from exercising remedies against the debtor during its bankruptcy case. The Bankruptcy Code contains "safe harbor" provisions, however, aimed at protecting parties' rights and remedies under a swap agreement, notwithstanding the automatic stay. These provisions permit a party to a swap agreement to terminate, liquidate and accelerate the swap agreement upon its counterparty's bankruptcy, and setoff any net loss against collateral posted in connection with the swap agreement, all without the need for court approval. The Bankruptcy Code's safe harbor provisions are inapplicable to a return of excess collateral posted for the debtor's benefit. Thus, upon the bankruptcy of the swap dealer counterparty, if the collateral were posted directly with such entity, the automatic stay would preclude the other party from taking actions to collect its excess collateral, and the other party would be left with a general unsecured claim for return of its collateral.

Defaulting or Affected Party, and the Pledgor (the buy-side party to the swap) sends the Pledgor Access Notice to the Securities Intermediary following an Event of Default or Specified Condition where the Secured Party is the Defaulting or Affected Party. Also, each letter contains two versions identified as Version A and B. Version A permits the party sending the notice to withdraw all of the collateral in the account whereas Version B requires that the party sending the letter identify the Independent Amount which is required to remain in the account and the Independent Amount which is excess collateral. For example, if the Pledgor is sending Version B of the Pledgor Access Notice, it would only be entitled to withdraw the Excess Independent Amount and the Required Independent Amount would remain in the account for the benefit of the Secured Party even if the Secured Party is the Defaulting or Affected Party under the ISDA Master Agreement.

The ISDA Tri-party IA Notices do not address two of the key points that are generally addressed during negotiations. Some swap dealers may want the right to dispute the occurrence of an Event of Default or Specified Condition, although each of these terms has a relevant cure or notice requirement in the ISDA Master Agreement. Separately, swap dealer counterparties may want to incorporate a waiting period or delayed release time between the time the Notice of Exclusive Control or Pledgor Access Notice is delivered to the Securities Intermediary and is declared an effective notice by the Securities Intermediary and the time when the Securities Intermediary releases the collateral to the Secured Party or Pledgor (as the case may be). Proposed waiting periods or delayed release times are generally 2 business days.

The five major elections to be made in the Notice of Exclusive Control and Pledgor Access Notice are:

1. A swap counterparty selects whether it may obtain the collateral because of the occurrence of a Specified Condition and/or Event of Default, or it may refer to specific events as they appear in the Schedule or pre-printed form of the ISDA Master Agreement;
2. A swap counterparty selects whether the mere occurrence of an Event of Default or Specified Condition will give rise to the right to obtain the collateral, or whether the right commences after an Early Termination Date has either occurred or been designated as a result of the occurrence of an Event of Default or Specified Condition;
3. The swap counterparty must provide information on where the collateral should be transferred to it;
4. The parties may identify whether the Event of Default or Specified Condition is an “indisputable event,” which in most cases refers to a Bankruptcy Event. When a party identifies a particular event as an “indisputable event” in the Notice of Exclusive Control or Pledgor Access Notice, it is representing to the Securities Intermediary that dispute resolution procedures, delivery delays or similar conditions will not apply to the release of collateral. If the “indisputable event” is defined as a “Bankruptcy Filing Evidence Event,” the parties are required to provide at least one piece of evidence of the “indisputable event,” but providing evidence is not a condition for the Securities Intermediary releasing the collateral; and
5. The parties may choose to require that the Securities Intermediary forward a copy of each notice to the other party.

The third document included in the ISDA Tri-party IA Notices is the Conflicting Instructions Provision, which will supplement the account control agreement. This document determines what the Securities Intermediary should do if it receives a Notice of Exclusive Control as well as a Pledgor Access Notice. The options are: (i) the first document delivered to the Securities Intermediary wins (subject to Securities Intermediary’s ability to declare when each became effective and subject to any dispute resolution provisions), (ii) the Notice of Exclusive Control prevails or (iii) the Securities Intermediary may elect to refrain from releasing the collateral until it obtains a legal opinion, joint written instruction from the Secured Party and Pledgor or final court order.

Authored by Paul N. Watterson, Jr., Craig Stein and Nanette Aguirre.

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Alert

CFTC Staff Issues New FAQ Guidance for CPO, CTA Registration and the "De Minimis" Exemption

August 24, 2012

Effective Dec. 31, 2012, the Commodity Futures Trading Commission ("CFTC") Rule 4.13(a)(4)[1] exemption from registration as a commodity pool operator ("CPO") will no longer be available. Private fund managers who rely on this exemption must find an alternative exemption or otherwise register with the CFTC as a CPO. In addition, mutual funds and other registered investment companies will have to comply with new conditions under amended Rule 4.5 if they engage in futures, commodity options or swap transactions.

The CFTC retained the "de minimis" exemption from CPO registration for CPOs of funds that have de minimis futures activity (i.e., either (1) the aggregate initial margin and premiums on commodity interest positions does not exceed five percent of the liquidation value of the fund's portfolio (including unrealized gains and losses) or (2) the aggregate notional value of such positions does not exceed 100 percent of the liquidation value of the fund's portfolio (including unrealized gains and losses)).

The CFTC is also imposing new data reporting requirements for registrants under Forms CPO-PQR and CTA-PR.[2]

FAQ Guidance

On Aug. 14, 2012, the CFTC staff issued a set of responses to frequently asked questions to clarify rule changes with respect to registration and exemptions for CPOs and commodity trading advisors ("CTAs"). The following is a brief overview of the more notable points:

- **Valuation of Swaps for Net Notional Calculation:** With respect to the net notional threshold for the Rule 4.13(a)(3) de minimis exemption, the CFTC staff is taking the position that the "notional value" is the same as the amount required to be reported by swap counterparties as the notional amount.
- **Special Purpose Vehicles:** Wholly owned subsidiaries of private or registered commodity pools (i.e., SPVs) are themselves commodity pools and would thus need to either meet the de minimis test on their own accord (i.e., by looking directly at the SPV portfolio) or otherwise have the CPO of the SPV register. However, even if the CPO of the SPV would be required to register, it would be exempt from providing certain disclosure documents and financial statements to the pool.

[1] CFTC Rule 4.13(a)(4), which was adopted in 2003, generally exempted from CFTC registration CPOs of funds whose natural person investors are "qualified eligible persons" ("QEPs") within the meaning of CFTC Rule 4.7(a)(2) (a category that includes "qualified purchaser" investors in funds offered pursuant to Section 3(c)((7) of the Investment Company Act of 1940) and whose non-natural person investors are either QEPs or "accredited investors" as defined in Securities and Exchange Commission ("SEC") Regulation D.

[2] Additional details about these changes can be found in SRZ's July 20, 2012 *Alert*, Update on Recent CFTC Actions Affecting Fund Managers.

- **Form CPO-PQR:** The CFTC staff has stated that no additional guidance with respect to the Form CPO-PQR will be forthcoming until next year. As such, the CFTC staff has indicated that CPOs and CTAs should make “reasonable assumptions consistent with a good faith effort” in their CPO-PQR filings.
- **Exempt Funds Transitioning to 4.7 “Regulation Lite” in 2013:** Funds relying on Rule 4.13(a)(4) that will transition to registering and relying on Rule 4.7 will not be required to reconfirm that all existing investors in the fund are QEPs.
- **Funds of Funds:** The CFTC staff has reaffirmed that the Appendix A guidance (which was removed when the CFTC amended the applicable rules) for funds of funds relying on the de minimis exemptions under Rule 4.13(a)(3) (private funds) or Rule 4.5 (registered funds), can still be relied upon until the CFTC adopts revised guidance. In practice, funds of funds have found compliance with Appendix A guidance to be difficult.
- **Temporarily Exceeding the 4.13(a)(3) De Minimis Thresholds:** The CFTC staff confirmed that a fund would not be in violation of the Rule 4.13(a)(3) exemption if it temporarily crosses the de minimis thresholds so long as the fund is in compliance with the trading threshold at the time a position is established.
- **Applicability of Prior No-Action Letters to Boards of Directors and General Partners:** The CFTC staff has historically issued no-action letters allowing a general partner or board of directors to not register as a CPO if, among other things, it delegates its rights and obligations with respect to the operation of the pool to the investment manager and agrees to a joint and several liability agreement for violations of the Commodity Exchange Act. The CFTC staff has indicated that firms may rely on these no-action letters without seeking independent no-action relief.
- **2012 Annual Report Filings**: While registered CPOs are required to file year-end annual financial reports, the CFTC staff has confirmed that CPOs who are having their exemption withdrawn on Jan. 1, 2013 (and thus registering as of that date) will only be required to file their first annual report for the fiscal year 2013.
- **Bona Fide Hedging Excluded for Registered Funds Relying on the De Minimis Exemption:** While registered funds may exclude bona fide hedging when determining if a fund is below the de minimis thresholds, the CFTC staff has confirmed that bona fide hedging does not extend to derivatives positions used to manage cash and other risk management positions that don’t otherwise meet the definition of bona fide hedging.

For additional details, the full FAQ text can be found at:
http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/faq_cpocta.pdf.

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Alert

Update for Swap Counterparties: New Web Portal Launched to Assign CFTC Interim Compliant Identifiers

August 23, 2012

The Depository Trust & Clearing Corporation (DTCC) and SWIFT have launched a Web portal to begin assigning CFTC Interim Compliant Identifiers (CICIs) as required by the CFTC's Data and Recordkeeping Rule. All swap counterparties are required to be identified by a CICI. All swap counterparties currently adhering to the ISDA Dodd-Frank Protocol are required to list this identifier in their Questionnaires and in some cases may not have to provide operative documentation or sensitive information as part of this protocol if such has already been provided to DTCC and SWIFT when registering for their CICI. Swap counterparties with CICIs would be deemed in compliance with ISO 17442, which sets forth the terms of a global framework for Legal Entity Identifiers (LEI) from the Financial Stability Board (FSB) and the G20. ISO 17442 is aimed at assigning a legal identifier to all swap counterparties trading OTC swaps globally in an effort to minimize systemic risk.

To register for a CICI, go to http://www.ciciutility.org/.

To register for the ISDA Dodd-Frank Protocol, go to http://www2.isda.org/functional-areas/protocol-management/submit-adherence-letter/.

If you have any questions, please contact *Paul Watterson, Jr*., *Craig Stein*, *Nanette Aguirre* or your attorney at Schulte Roth & Zabel.

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Memorandum

The New Derivatives Definitions — What Fund Managers Need to Know

August 21, 2012

Introduction

In July 2012, the Commodity Futures Trading Commission ("CFTC") and the Securities Exchange Commission ("SEC" and, together with the CFTC, the "Commissions") jointly adopted new rules and interpretations (the "Definitions Release") to define the terms "swap," "security-based swap," and "security-based swap agreement" (collectively, "Product Definitions"), to provide for the joint regulation by the Commissions of "mixed swaps" and to impose record-keeping requirements with respect to "security-based swap agreements." The Definitions Release was published in the Federal Register on Aug. 13, 2012. With certain exceptions, the effective date of the Definitions Release will be Oct. 12, 2012.

The publication of the Definitions Release will result in many of the rules previously adopted by the Commissions pursuant to Title VII ("Title VII") of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") going into effect over the next several months. The Definitions Release is an important part of this framework because it helps determine the types of transactions that will be subject to regulation by the CFTC, the SEC or both under Title VII and the regulations adopted thereunder.

In particular, the publication of the Definitions Release directly affects several areas of importance to the private funds industry:

- **CFTC Registration:** The Definitions Release provides much needed guidance on what kinds of transactions will be included or excluded as swaps for purposes of the calculations to determine the availability of the de minimis exemption to the manager of a private fund from the commodity pool operator ("CPO") registration requirements under the Commodity Exchange Act, as amended (the "CEA").
- **CFTC Regulation of Swaps:** The Definitions Release triggers the effectiveness of several new CFTC regulations governing swaps and other derivatives that will affect private funds and fund managers, including recordkeeping and disclosure requirements, anti-fraud and anti-manipulation rules, mandatory clearing of certain types of swaps, and position limits, among other new requirements.
- **SEC Regulation of Security-Based Swaps:** The SEC's inclusion of security-based swaps in the definition of "security" for purposes of both the Securities Exchange Act of 1934, as amended (the "Exchange Act") and the Securities Act of 1933, as amended (the "Securities Act") makes security-based swaps subject to regulation as securities under the federal securities laws, giving the SEC significant new regulatory and enforcement power over such derivatives.

CFTC Registration

The Product Definitions implicate a range of commodity law requirements governed by statutes and regulations enforced by the CFTC because derivatives that are "swaps" are now included in the definition of "commodity interests" for purposes of the CEA. One of the most significant effects of the Definitions Release to fund managers is its applicability to the de minimis exemptions available under Rule 4.13(a)(3) (applicable to private investment funds) and Rule 4.5 (applicable to funds registered under the Investment Company Act of 1940, as amended) from the CPO registration requirements under the CEA. As explained in greater detail in our *Alerts* of July 20, 2012 and Feb. 10, 2012 ("Update on Recent CFTC Actions Affecting Fund Managers" and "CFTC Finalizes Significant Rule Changes Affecting Fund Managers and Investment Companies," respectively), starting in Dec. 31, 2012, fund managers will not be able to claim an exemption from CPO registration pursuant to Rule 4.13(a)(4) and swaps will be considered "commodity interests" for purposes of the exemptions available under Rule 4.13(a)(3) and Rule 4.5. Therefore, most private fund managers will need to rely on the de minimis exemption available under Rule 4.13(a)(3) to avoid having to register as a CPO.

The de minimis exemption is available when a private fund engages in a de minimis level of "commodity interest" transactions. Traditionally, the exemptions required calculations that included only futures, commodity option and retail forex transactions. As of Jan. 1, 2013, these calculations will also include "swaps" regulated by the CFTC. The Definitions Release now provides clarity regarding precisely which sort of derivatives and similar transactions will be treated as swaps and must be included in the calculations related to the de minimis exemptions.

If a fund cannot qualify for the applicable de minimis exemption, the consequences to its manager can be significant.[1] For instance, if a private fund cannot qualify for the de minimis exemption under Rule 4.13(a)(3),[2] the investment manager will be required to register as a CPO,[3] an affiliated entity may be required to register as a commodity trading adviser ("CTA") and the associated persons of the CPO ("Associated Persons") must register under the CEA. A CPO must also become a member of the National Futures Association ("NFA") and its Associated Persons must become associate members of NFA and provide fingerprints to NFA on a completed fingerprint card. Associated Persons must also pass the Series 3 exam administered by the Financial Industry Regulatory Authority ("FINRA"). CPOs and CTAs will also be subject to the various reporting requirements with CFTC and NFA, including new reporting requirements under forms CPO-PQR and CTA-PR.

The release of the Product Definitions also allows for a determination of whether fund managers and other financial institutions will be required to register as swap dealers ("SDs") or major swap participants ("MSPs"),[4] since only swaps under CFTC jurisdiction need be considered for purposes of determining whether a firm is

[1] Other than the de minimis exemption under Rule 4.13(a)(3), even foreign advisors managing non-U.S. private funds that only invest in foreign commodity interest positions have no other exemptions available to them, so long as the fund has even just one U.S. investor. While there is no specific exemption for family offices, the CFTC has indicated that family offices may rely on certain CFTC no-action relief letters provided to them in the past.

[2] There is no exemption for commodity interest positions that were entered into for hedging purposes. Also, in order for a private fund to rely on Rule 4.13(a)(3), all of the investors in the fund must be either an accredited investor or a non-US person (or other "qualified eligible persons") and either (i) the aggregate of all initial margins and premiums on commodity interests and security futures positions must at all times be no more than 5 percent of the liquidation value of the fund's portfolio or (ii) the aggregate net notional value of the commodity interest positions cannot exceed at any time 100 percent of the liquidation value of the fund's portfolio, after taking into account unrealized profits and losses. The fund must also be offered in a private placement, and it cannot be marketed to the public or as a vehicle for investing in commodity futures or commodity options markets. On July 17, 2012, the Managed Funds Association ("MFA") submitted comments to the CFTC urging it to, among other things, harmonize Rule 4.13(a)(3) with the Jumpstart Our Business Startups Act (the "JOBS Act"), which eliminates the prohibition on general solicitation or advertising in connection with the non-public offering of securities. In addition, MFA requested that the CFTC grant interim temporary no-action relief to CPOs relying on Rule 4.13(a)(3) from the prohibition on marketing to the public.

[3] Certain managers may be able to take advantage of the so-called "registration lite" under Rule 4.7 promulgated under the CEA which is available to pools that are offered only to qualified eligible persons and meet certain other criteria.

[4] As detailed in SRZ's May 22, 2012 *Alert*, "SEC and CFTC Publish Entity Rule Definitions: Impact on Private Investment Funds," most private investment funds are not expected to fall within the definitions of SD or MSP, but the obligations of SDs and MSPs may affect private investment funds (for example, SDs or MSPs may be obligated to request additional collateral under derivative transactions with a private investment fund). Managers with questions regarding the SD/MSP status of their managed funds should contact their SRZ attorney.

required to register as an SD or MSP. Although it is unlikely that a private fund will be considered to be an SD or MSP, these rules are still relevant to most private funds that enter into swaps because a private fund's dealer counterparties will have to register as SDs. The publication of the Product Definitions will trigger new obligations for SDs/MSPs, including CFTC business conduct standards that require swap dealers to conduct due diligence on fund managers and private funds and to obtain certain representations from their fund counterparties and fund managers. The International Swaps and Derivatives Association, Inc. ("ISDA") has prepared documentation that will incorporate by reference into a fund's existing swap documentation the terms and conditions necessary for the fund's SD counterparties to comply with the CFTC's new business conduct standards, recordkeeping and reporting requirements. Private funds may adhere to the ISDA August 2012 DF Protocol to make certain representations and agreements to avoid intrusive due diligence and to continue trading without any interruptions.

CFTC Regulation of Swaps

The Definitions Release also triggers many CFTC requirements that apply to all swap transactions, irrespective of a swap counterparty's registration status with the CFTC, such as certain disclosure, reporting and recordkeeping requirements, position limits applicable to certain swaps,[5] the anti-manipulation and anti-fraud final rules applicable to all swaps,[6] and clearing obligations for certain swaps.

Although many of the reporting and recordkeeping requirements apply only to SDs and MSPs, a private fund may be subject to certain significant recordkeeping requirements, such as a requirement that it maintain "full, complete and systematic" records with respect to each swap to which it is a party. For example, SDs and MSPs will be required to conduct additional due diligence on managers and require the manager of a private fund counterparty to provide updated representations and on-going reports and other information (such as records that can support the accuracy of the information reported to swap data repositories). Therefore, a private fund manager will need to consider updating its record retention and recordkeeping policies to permit it to have such information accessible in a usable format.

The CFTC has adopted a Final Interim Rule imposing position limits on swaps, futures and options on 28 physical commodities, expanding the types of commodities to which position limits apply for futures and options, and including for the first time swaps that are "economically equivalent" to such futures and options. The position limits cap the maximum amount of futures, options and economically equivalent swaps that a trader may control with respect to such commodities at any given time.

The general prohibition against fraud, manipulation and deception by SDs/MSPs established by the CFTC's Business Conduct Rule prohibits an SD/MSP from engaging in "any act, practice, or course of business that is fraudulent, deceptive, or manipulative." The anti-fraud provision is identical to the general anti-fraud rule contained in CEA Section 4s(h). The CFTC has also imposed a fair dealing obligation on SDs/MSPs, requiring that an SD/MSP communicate in a "fair and balanced manner based on principles of fair dealing and good faith."

Although the CFTC has not yet required that any swap be cleared, it has proposed clearing requirements for certain credit default swaps and interest rate swaps and is expected in the future to require clearing of additional types of swaps that are currently cleared, or will be cleared, by one or more regulated clearinghouses. A private fund that enters into a cleared swap transaction will be subject to margin requirements imposed by the relevant clearinghouse as well as the member of the clearinghouse through which the private fund enters into such transaction.[7] Swaps that must be cleared must also be executed on a futures or securities exchange or a swap execution facility. Rules governing these execution facilities are not yet final.

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[5] The CFTC's Final Interim Rule and Proposed Rule relating to position limits may be found at www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-28809-1a.pdf and www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-12526a.pdf, respectively.

[6] See www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-1244a.pdf for the CFTC's Business Conduct Rule, which sets forth these rules.

[7] Private fund managers will need to prepare to negotiate and enter into futures account client agreements or similar clearing agreements with their dealer counterparties with respect to swaps that are subject to clearing requirements.

SEC Regulation of Security-Based Swaps

The Products Definitions also implicate a range of securities law requirements governed by statutes and regulations enforced by the SEC because derivatives and similar transactions that are "security-based swaps" are now included in the definition of "security" for purposes of both the Exchange Act and the Securities Act. For instance, a private fund that enters into a security-based swap referencing an equity security may be subject to a number of Section 13(d) beneficial ownership rules under the Exchange Act (including the reporting requirements thereunder) because it may be deemed to have beneficial ownership of the equity security in certain situations, including: (i) where a security-based swap, by its terms or otherwise,[8] gives a person voting or investment power over the underlying security; (ii) where a security-based swap is used with the purpose or effect of divesting or preventing the vesting of beneficial ownership as part of a plan or scheme to evade the beneficial ownership reporting requirements; and (iii) where a security-based swap, by its terms or otherwise, gives a person the right to acquire the underlying security within 60 days (or at any time if the person holds such right to acquire the underlying security with the purpose or effect of changing or influencing control of the issuer).

There are also implications under Section 16 of the Exchange Act for private fund managers to consider. Security-based swaps must be included in a private fund manager's Section 16 reporting, including: (i) Rule 16a-1(a)(1) which uses the beneficial ownership tests of Section 13(d) to determine whether a person is subject to Section 16 as a greater than 10 percent beneficial owner and (ii) Rule 16a-1(a)(2) which defines pecuniary interest for purposes of reporting obligations and related short-swing profit analysis.

Private fund managers should also be aware that security-based swaps will be treated as securities for purposes of anti-fraud and manipulation provisions of the U.S. federal securities laws.[9] However, like many of the rules related to security-based swaps, proposed antifraud Rule 9j-1 under the Exchange Act (which would apply not only to offers, purchases and sales of security-based swaps, but also to cash flows, payments, deliveries, and other ongoing obligations and rights that are specific to security-based swaps), will not go into effect until a date specified by the SEC after the publication of the Product Definitions.

The SEC stated that because of the interconnectedness of the Product Definitions with the remaining rules related to security-based swaps, the SEC is requesting comments on the sequencing of compliance dates for industry participants on proposed rules. (*See* www.sec.gov/rules/policy/2012/34-67177.pdf.) However, once the SEC publishes the compliance dates, fund managers will have to comply with similar SEC rules related to recordkeeping and reporting (including real time reporting) with respect to security-based swaps.

Dodd-Frank also requires the SEC to issue rules related to position limits for security-based swaps,[10] but the SEC has not issued a proposed rule for security-based swap position limits. The SEC will also implement the rules related to clearing security-based swaps.

Swaps and Security-Based Swaps Subject to Regulation

Swaps, Security-Based Swaps and Mixed Swaps
Each of the CFTC and SEC have certain responsibilities for administering and enforcing the regulatory regime created by Title VII. The CFTC is given regulatory authority over swaps, the SEC is given regulatory authority over security-based swaps (which are now included in the definition of "security" for purposes of both the Exchange Act and the Securities Act), and the Commissions have joint authority over mixed swaps.[11]

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[8] This would include ways to exert influence in practice through consultations and other informal "handshake" agreements.

[9] These include Section 10(b) of the Exchange Act, Rule 10b-5 and Section 17(a) of the Securities Act.

[10] See Dodd-Frank § 763(h).

[11] In addition, the SEC is given antifraud authority and certain other authority over security-based swap agreements ("SBSAs"), as well as access to information disclosed by CFTC-reporting entities relating to SBSAs. SBSAs are swaps involving securities over which the CFTC has regulatory and enforcement authority and include swaps on broad-based security indexes and swaps on exempted securities (other than municipal securities), such as U.S. Treasury bonds.

Whether a Title VII Instrument[12] is a swap or a security-based swap (or both, in which case the Title VII Instrument would be a mixed swap) will be determined by "the facts and circumstances relating to the Title VII Instrument prior to execution, but no later than when the parties offer to enter into the Title VII Instrument."[13] The characterization of a Title VII Instrument as a swap or security-based swap may change over time if the Title VII Instrument is amended, modified or otherwise adjusted during its term.

The characterization of a Title VII Instrument as a swap, security-based swap or mixed swap will be determined based on the subject of the transaction embodied by such Title VII Instrument.

Generally, if the Title VII Instrument references a single security or loan, or a "narrow-based security index,"[14] the Title VII Instrument will be a security-based swap subject to regulation by the SEC but if the Title VII Instrument references commodities, assets that are not "securities" under federal law (i.e., most currency products), a group of securities (unless such group qualifies as a narrow-based securities index), an index that is not a narrow-based security index, or one or more "exempt securities" (as discussed below), the Title VII Instrument will be a swap, subject to regulation by the CFTC.

A mixed swap is a swap with both "swap" and "security-based swap" characteristics and is subject to joint regulation by the Commissions. Since mixed swaps are regulated by the CFTC, they also must be counted for purposes of all CFTC rules, including the rules related to CPO/CTA registration requirements. The Definitions Release establishes two rules with respect to mixed swaps. First, in the case of a bilateral, uncleared mixed swap,[15] where one of the parties is dually registered with both Commissions, all applicable provisions of the federal securities laws, as well as certain key provisions of the CEA, will apply to such swap. Second, where the applicable provisions of federal securities laws and the CEA (and the rules and regulations thereunder) are parallel or duplicative, a party to a mixed swap may request that the Commissions by joint order permit such party to comply with either the federal securities laws or the CEA.

The following chart contains a non-exhaustive list of Title VII Instruments and their classification under the Definitions Release. It does not contain all types of Title VII Instruments, is intended as a summary for reference purposes only and does not constitute legal advice. Private investment funds and managers should consult their SRZ attorney for an analysis of specific Title VII Instruments.

[12] As used herein (and in the Definitions Release), "Title VII Instrument" means a swap or a security-based swap.

[13] Definitions Release, p. 202.

[14] The CEA and Exchange Act both define the term "narrow-based security index" as an index satisfying, among other things, one of the following four requirements: (1) it has nine or fewer components; (2) one component comprises more than 30 percent of the index weighting; (3) the five highest weighted components comprise more than 60 percent of the index weighting or (4) the lowest weighted components comprising in the aggregate 25 percent of the index's weighting have an aggregate dollar value of the average daily volume over a six-month period of less than $50 million ($30 million if there are at least 15 component securities), subject to certain exceptions specified in the definition of narrow-based security index. Definitions Release, pp. 235-236. In addition, if (i) a Title VII Instrument is based on a portfolio of securities selected by the counterparties or created by a third-party index provider at the behest of one or both counterparties and (ii) the counterparties directly or indirectly (e.g., through an investment adviser or through a third-party index provider) have discretionary authority to change the composition or weighting of securities in the security portfolio, that security portfolio will be treated as a narrow-based security index and the Title VII Instrument will be treated as a security-based swap. Definitions Release, p. 288.

[15] A mixed swap that is not to be cleared. See Definitions Release, p. 314, footnote 950.

Swap	Security-Based Swap	Mixed Swap
Total return swaps ("TRS") referencing a broad-based security index (whether comprising debt securities or equity securities)[16]	TRS referencing a narrow-based security index (whether comprising debt securities or equity securities)	TRS referencing both a broad-based security index and a narrow-based security index
TRS referencing an exempted security[17] (other than a municipal security) or a basket of two or more securities that is not a narrow-based security index or a basket of two or more non-security loans[18]	TRS referencing a single security or a single non-security loan[19]	TRS on a single security with an embedded interest rate hedge or an embedded commodities futures or option
Credit default swaps ("CDS") referencing an exempted security (other than a municipal security) or a basket of two or more securities that is not a narrow-based security index or a basket of two or more non-security loans (whether or not such security is a narrow-based security index), including CDS whose settlement is governed by an ISDA-sponsored auction settlement protocol[20]	CDS referencing a single security or a single non-security loan or a narrow-based security index, including CDS whose settlement is governed by an ISDA-sponsored auction settlement protocol	CDS referencing both a broad-based security index and a narrow-based security index or a CDS referencing a broad-based security index and requiring physical settlement of a non-exempted security or a loan
Swaps based on rates or yield of a U.S. Treasury security or another exempt security, or of multiple U.S. Treasury securities, exempt securities or securities	Swaps based on the yield of a single security (other than U.S. Treasury securities or other exempt securities)	
Dividend swaps referencing a broad-based security index	Dividend swaps referencing a single security or narrow-based index of securities	

[16] Any index that is not a narrow-based security index is a broad-based security index.

[17] An "exempted security" is a security that is an exempted security under Section 3 of the Securities Act, such as securities issued or guaranteed by the United States, bank certificates of deposit and other securities issued or guaranteed by a bank, certain bills of exchange or banker's acceptance and certain securities issued by a savings and loan association.

[18] The Commissions determined that a TRS on a group or index of non-security loans is not a security-based swap because the definition of narrow-based security index applies only to securities and not to non-security loans.

[19] The Definitions Release defines "non-security loans" as loans that are not securities.

[20] The Definitions Release clarifies that transactions structured as securities (including a security-based swap) under the federal securities laws are not swaps under the anti-evasion rules set forth in the Definitions Release. Therefore, credit-linked notes, equity-linked notes and similar structured notes should not be considered to be swaps.

Swap	Security-Based Swap	Mixed Swap
Futures based on U.S. Treasury securities, other exempt securities (other than municipal securities) or foreign government debt securities that are exempt securities pursuant to Exchange Act Rule 3a12-8[21]	Futures based on a single security,[22] including foreign government debt securities not subject to the exemption provided by Exchange Act Rule 3a12-8	
Correlation swaps referencing a broad-based security index or any commodity or commodity index		
Interest rate swaps and basis swaps		
Cross-currency swaps, currency swaps, currency options, foreign currency options, foreign exchange ("FX") options, FX rate options, FX forwards and FX swaps[23] (but excluding foreign currency option traded on a National Securities Exchange; and spot transaction and security conversion transaction[24])		
Commodity swaps, including swaps based on agricultural commodities, metals, energy and other commodities		
Weather and emissions swaps		
Guarantee of a Title VII Instrument that is a swap	Guarantee of a Title VII Instrument that is a security-based swap	Guarantee of a Title VII Instrument that is a mixed swap

[21] The foreign governments whose debt securities are exempted by Rule 3a12-8 are the United Kingdom, Canada, Japan, Australia, France, New Zealand, Austria, Denmark, Finland, the Netherlands, Switzerland, Germany, Ireland, Italy, Spain, Mexico, Brazil, Argentina, Venezuela, Belgium and Sweden. The Rule 3a12-8 exemption applies only to Title VII Instruments that are futures based on the exempted foreign government debt securities. A Title VII Instrument directly referencing foreign government securities (including securities issued by governments listed above) will be either a security-based swap or a swap (or a mixed swap) under the same analysis as any other Title VII Instrument referencing securities.

[22] While a swap on a security future is not considered a swap, a security future itself still must be considered for purposes of the de minimis tests. (See footnote 2 for a summary of the de minimis test under Rule 4.13(a)(3).)

[23] It is important to note, that while all FX swaps and FX forwards have been defined as swaps, the U.S. Department of the Treasury is in the process of determining whether to exempt such instruments, in which case, these instruments would no longer be considered swaps. However, a determination by the U.S. Department of the Treasury will have no effect on other FX derivatives (such as FX options, currency swaps, and non-deliverable forwards); they will still be considered swaps.

[24] While not considered security-based swaps, foreign currency options traded on a National Securities Exchange and spot transactions and security conversion transactions are excluded from the definition of a "swap."

Title VII Instruments Difficult to Categorize
To the extent that there are Title VII Instruments that are difficult to categorize as either swaps or security-based swaps, any interested person may request a joint interpretation from the Commissions regarding the categorization of such instruments by submitting a request to the Commissions (which request would include a deadline for responding to such request). The requesting party must provide certain information regarding the Title VII Instrument, including a supporting analysis and certain other documentation to the SEC and CFTC.

Anti-evasion Rules
Under the anti-evasion rules adopted by the CFTC, swaps will include agreements, contracts or transactions that are willfully structured to evade the provisions of Title VII governing the regulation of swaps. The Commissions will look beyond the documentation of a Title VII Instrument to examine its actual substance and purpose. However, Rule 1.6(d) provides that no agreement, contract or transaction structured as a security (including a security-based swap) under the federal securities laws shall be deemed a swap. Therefore, credit-linked notes, equity-linked notes and similar structured notes should not be considered to be swaps.

Derivatives and Other Products Exempt from Regulation

Although the Commissions did not modify the definitions of "swap" and "security-based swap" found in Section 721 of Dodd-Frank, they excluded certain contracts and/or transactions that have "swap-like" features but that will be excluded from the Product Definitions. The Commissions created four broad categories of products that are generally exempted from the Product Definitions: (i) loan participations, (ii) insurance, (iii) nonfinancial commodity forwards and (iv) consumer and commercial transactions.

Loan Participations
The Commissions excluded loan participations meeting certain qualifications from regulation as swaps and security-based swaps. In order to qualify for the exclusion, a loan participation must "represent a current or future direct or indirect ownership interest in the loan or commitment that is the subject of the loan participation."[25]

In determining whether a loan participation represents a current or future direct or indirect ownership interest, the Commissions will expect a participation to have all of the following characteristics:

1. The grantor of the loan participation is a lender under, or a participant or subparticipant in, the loan or commitment that is the subject of the loan participation.
2. The aggregate participation in the loan or commitment that is the subject of the loan participation does not exceed the principal amount of such loan or commitment and does not otherwise grant to the participant, in the aggregate, a greater interest than the grantor holds.
3. The entire purchase price for the loan participation is paid in full when acquired and not financed.[26] The Commissions believe a purchase price would not be paid in full if the grantor of the loan participation extends financing to the participant or if such participant levers its purchase, including by posting collateral to secure a future payment obligation.
4. The loan participation provides the participant all of the economic benefit and risk of the whole or part of the loan or commitment that is the subject of the loan participation.[27]

[25] Definitions Release, p. 162-163.

[26] The Commissions expressly provided that the financing or taking leveraged exposure to a loan participation, including by posting collateral to secure a future payment obligation, would not constitute the payment in full of the purchase price.

[27] Definitions Release, p. 163.

Insurance

The Commissions excluded insurance products[28] from regulation as swaps and security-based swaps if such products comply with certain non-exclusive safe harbor rules (the "Insurance Safe Harbor").[29] The Insurance Safe Harbor consists of two tests: first, an insurance product must either (i) satisfy the conditions set forth in the "Product Test" established by the Commissions or (ii) be one of the "Enumerated Products" expressly excluded from regulation under Title VII ((i) and (ii) collectively, "Exempt Insurance Products"), and second, the Exempt Insurance Product in question must be provided by an insurer that satisfies the "Provider Test" established by the Commissions.

The Insurance Safe Harbor is a non-exclusive safe harbor. An agreement, contract or transaction that does not qualify for the Insurance Safe Harbor is not therefore automatically a swap or a security-based swap.[30] It should be noted that products that have been offered by insurance companies or their affiliates in the past, such as credit default swaps and "transformer" credit default swap products that provided insurance on tranches of securitization notes, such as notes issued by collateralized debt obligation issuers, would not meet the Insurance Safe Harbor.

In addition to the Insurance Safe Harbor, the Commissions also recognized that products traditionally regulated as insurance would remain so, by providing for a grandfather provision (the "Insurance Grandfather") in the rules under the CEA and Exchange Act. The Insurance Grandfather provides "that an agreement, contract, or transaction entered into on or before the effective date of the Product Definitions will be considered insurance and not fall within the Product Definitions, *provided that* at such time it was entered into, such agreement, contract, or transaction was provided in accordance with the Provider Test."[31]

The Forward Contract Exclusion

Noting that forward contracts are primarily intended to transfer ownership of a commodity and not solely to transfer price risk, the CFTC adopted an interpretation excluding from regulation under Title VII "any sale of a nonfinancial commodity[32] or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." With respect to "book-out" transactions, where parties to multiple forward contracts settle offsetting positions with each other by foregoing delivery and negotiating payment of differences pursuant to a separately negotiated cancellation agreement, the CFTC also retained the "Brent Interpretation," allowing forwards to qualify for the forward contract exclusion if they have binding delivery obligations (and no right to cash settle or otherwise net delivery obligations) but are unwound pursuant to a subsequent, separately negotiated book-out agreement.[33]

If a nonfinancial forward contract contains an embedded commodity option or options, the forward contract will be a nonfinancial forward contract (and not a swap), if the embedded option (i) will be used to adjust the forward contract price, but does not undermine the overall nature of the contract as a forward contract; (ii) does not target the delivery term, so that the predominant feature of the contract is actual delivery; and (iii) cannot be severed and marketed separately from the overall forward contract in which it is embedded.[34]

The Commissions also adopted the Proposing Release's interpretation with respect to mortgage-backed securities ("MBS") sold in the "to be announced" ("TBA") market, which provides that forward sales of MBS in the TBA market would fall within: (i) the exclusion for sales of securities on a deferred settlement or delivery

[28] Definitions Release, p. 18.

[29] Definitions Release, p. 19.

[30] Any such agreement, contract or transaction would need to be analyzed under the Product Definitions to determine whether it is a swap, security-based swap or mixed swap. Definitions Release, p. 24-25.

[31] Definitions Release, p. 57.

[32] The CFTC defines "nonfinancial commodity" to mean a commodity that can be physically delivered and that is an exempt commodity or an agricultural commodity (as both such terms are defined in CEA Section 1a(20)); the CFTC also provided an interpretation stating that intangible commodities (for example, emissions allowances) can qualify as nonfinancial commodities if they can be "conveyed in some manner" and consumed. Definitions Release, pp. 93-95.

[33] In the Definitions Release, the CFTC expanded the application of the Brent Interpretation to all types of nonfinancial commodities (it previously applied only to oil). Definitions Release, pp. 78-82. As a result of the expansion of the Brent Interpretation, the CFTC withdrew the "Energy Exemption" adopted in 1993. Definitions Release, pp. 83-87.

[34] Definitions Release, p. 112.

basis, even MBS sold into the TBA market are not in existence at the time of such forward sale, and (ii) the exclusions for the purchase or sale of one or more securities on a fixed basis (or, depending on its terms, a contingent basis), and in each case would therefore fall outside the swap and security-based swap definitions.

Consumer and Commercial Transactions

The Commissions also adopted interpretations excluding various types of consumer and commercial transactions that may have "swap-like" features from regulation under Title VII. The Definitions Release provides a non-exhaustive list of excluded consumer and commercial transactions.[35] The Commissions noted that the types of contracts referred to above were not intended to be an exhaustive list and, in determining whether a particular contract was a swap or security-based swap, the Commissions would consider whether the contract in question had the characteristics common to the examples referred to in their interpretation, including whether the contract: (i) contains payment obligations, whether or not contingent, that are severable from the contract; (ii) is traded on an organized market or over-the-counter; (iii) in the case of consumer arrangements, involves an asset of which a consumer is the owner or beneficiary, or that a consumer is purchasing, or involves a service provided, or to be provided, by or to a consumer; and (iv) in the case of commercial arrangements, is entered into by commercial or non-profit entities as principals (or by their agents) to serve an independent commercial, business, or non-profit purpose, and other than for speculative, hedging, or investment purposes.[36]

Effective Dates of Title VII Regulation

With the adoption of the Definitions Release, the Title VII rulemaking required by Dodd-Frank is largely complete, and the various rules and regulations will become effective over the next several months. The following charts summarize the various dates by which the listed entities must comply with the specified rules and regulations, based on the Aug. 13, 2012 publication of the Definitions Release in the Federal Register. Please note that the summaries in the charts below are intended for informational purposes only and do not constitute legal advice with respect to any date or compliance requirement.

Effective Dates Related to CPOs/CTAs	
Rule	**Effective Date/Compliance Date**
CTAs whose sole commodity interest trading advice is with respect to swaps, and not futures, commodity options or retail foreign exchange (and, therefore, were not previously required to register), and that are not otherwise exempt, must register with the CFTC and NFA.	Oct. 12, 2012
Registered CPOs with assets under management of $5 billion or more (as of June 30, 2012) are required to submit their initial Form CPO-PQR for the quarter ending Sept. 30, 2012.	Nov. 29, 2012
Final Expiration of Rule 4.13(a)(4) exemption from CFTC registration (and the accompanying CTA exemption for 4.13(a)(4) pools under Rule 4.14(a)(8)(i)(D)); by Dec. 31, 2012, all CPOs and CTAs relying on 4.13(a)(4) (or similar no-action relief) must register with the CFTC and NFA (unless another exemption from registration applies).	Dec. 31, 2012

[35] The Definitions Release lists a number of types of consumer and commercial transactions, including contracts to acquire, lease, buy or sell property (real, personal, intellectual or other), loans or mortgages with variable rates, rate locks or rate caps, and loans with pricing linked to an underlying commodity or index (utility service based on energy cost or contracts with price escalators linked to CPI, for example), among others. Definitions Release, pp. 144-148.

[36] Definitions Release, p. 144.

Effective Dates Related to CPOs/CTAs	
Rule	**Effective Date/Compliance Date**
Swaps will be considered "commodity interests" for purposes of the Rule 4.13(a)(3) and Rule 4.5 de minimis tests.	Dec. 31, 2012
Registered CTAs are required to submit their first Form CTA-PR for the year ending Dec. 31, 2012.[37]	Feb. 14, 2013
Registered CPOs (as of 2012) with assets under management of at least $1.5 billion are required to submit their Form CPO-PQR for the quarter ending Dec. 31, 2012.[38]	March 1, 2013
Registered CPOs with assets under management of less than $1.5 billion are required to submit their initial Form CPO-PQR for the year ending Dec. 31, 2012 (excluding newly registered CPOs as of Jan. 1, 2013).[39]	March 31, 2013

[37] This date assumes that a CTA's fiscal year ends Dec. 31, 2012; the first filing is due 45 days after the last day of the fiscal year occurring after Dec. 15, 2012.

[38] CPOs with less than $5 billion as of June 30 (or those who were not yet registered) will be filing their initial Form CPO-PQR, while this would be the second filing for those with more than $5 billion. This will not be applicable to new registrants who choose to defer the effectiveness of a new CPO registration until Jan. 1, 2013.

[39] While new CPOs (i.e., registered as of Jan. 1, 2013) with less than $1.5 billion in assets under management will not be required to file their first CPO-PQR until 2014, there is still an NFA PQR filing requirement on a quarterly basis for all CPOs. Thus, for the quarter ending March 31, 2013, all CPOs will be required to make a filing, with the level of information required depending on assets under management.

Effective Dates Related to Swap Clearing	
Rule	**Effective Date/Compliance Date**
CFTC rules related to swap processing (customer clearing documentation and timing of acceptance for clearing) become effective for SDs.	Oct. 12, 2012
SDs/MSPs must comply with rules related to protection of customer contracts and collateral for cleared swaps.	Nov. 8, 2012
SDs, MSPs and "active funds" are required to clear with a derivatives clearing organizations ("DCO") certain classes of CDS/IRS.	Q1 2013 (approximately)[40]
All private funds (other than third-party subaccounts (as defined below)) are required to clear with a DCO certain classes of CDS/IRS.	Q2 2013 (approximately)[41]
(i) Accounts managed by an investment manager that is: (a) independent of and unaffiliated with the account's beneficial owner or sponsor, and (b) responsible for the documentation necessary for the account's beneficial owner to clear swaps ("third-party subaccounts"), (ii) ERISA plans and (iii) any other person not excepted from the relevant clearing requirement are required to clear with a DCO certain classes of CDS/IRS.	Q3 2013 (approximately)[42]

Effective Dates Related to Swap Reporting Rules	
Rule	**Effective Date/Compliance Date**
"Reporting entities" (clearing members and SDs) subject to CFTC's Large Swaps Trader Reporting for Physical Commodities (CFTC Part 20 regulations) are required to submit daily reports of their "reportable positions."	Sept. 21, 2012 (or Dec. 11, 2012, or later)[43]
SD/MSP non-real time reporting[44] of all CDS/IRS, including historical reporting (for both exchange-traded and OTC swaps).	Oct. 12, 2012

[40] 90 days following the publication of the final rule mandating clearing of the specified classes of CDS/IRS. While the 90-day timeframe has already been finalized, the clearing rules that specifically address IRS/CDS are currently in the proposal stage and can be found at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister072412.pdf.

[41] 180 days following the publication of the final rule mandating clearing of the specified classes of CDS/IRS.

[42] 270 days following the publication of the final rule mandating clearing of the specified classes of CDS/IRS.

[43] The CFTC has issued no-action relief which allows non-clearing member SDs (upon notifying the CFTC) to delay these reporting requirements until Dec. 11, 2012. The CFTC has also been provided discretion to allow certain SDs with resource limitations or a lack of expertise to delay reporting for an additional six months. (See CFTC No-Action Letter 12-04.)

[44] Reportable information generally includes swap creation data (including "primary economic terms" and valuation data), confirmation data (including a copy of the signed confirmation), and ongoing valuation and transaction modification data. See SRZ's Feb. 1, 2012 *Alert*, "CFTC Publishes Final Swap Data Rules and Real-Time Reporting Rules," for additional details.

Effective Dates Related to Swap Reporting Rules	
Rule	**Effective Date/Compliance Date**
CDS/IRS real-time data reporting requirement becomes effective for swaps data repositories (for both exchange-traded and OTC swaps).	Oct. 12, 2012
SD/MSP non-real time reporting of all swaps, including historical reporting (for both exchange-traded and OTC swaps).	Jan. 10, 2013
Real-time reporting requirements for swaps data repositories for all swaps.	Jan. 10, 2013
For non-SDs/MSPs that are party to a non-cleared swap (of any type) with another non-SD/MSP, one party to the swap will be required to report the swap's "primary economic terms" and deliver a copy of the confirmation relating to such swap (unless both parties are "non-U.S. persons").	April 10, 2013
For non-SDs/MSPs that are party to a non-cleared swap (of any type) with another non-SD/MSP, one party to the swap will be required to report the terms and conditions of the swap in electronic format (in the form used by SDs/MSPs and including all of the data fields in such form) (unless both parties are "non-U.S. persons").	Oct. 7, 2013

Effective Dates Related to General Regulation of SDs/MSPs	
Rule	**Effective Date/Compliance Date**
SDs and MSPs that are subject to the "Large Trader Reporting" rules (SEC Rule 13h-1) are subject to monitoring, recordkeeping and reporting requirements.	EFFECTIVE
SDs/MSPs required to be registered with the CFTC.	Oct. 12, 2012[45]
SDs/MSPs (or security-based SDs/MSPs), whether or not registered with the SEC or regulated by a prudential regulator must retain/disclose required information relating to swap transactions, including swap data and daily trading records.	Oct. 12, 2012
CFTC-imposed position limits for futures and swaps (initial spot-month limits for referenced contracts, initial non-spot month limits for legacy agricultural referenced contracts), as well as rules related to "bona fide" hedging, visibility reporting, aggregation, revised filing requirements and foreign boards of trade become effective.	Oct. 12, 2012[46]

[45] It is possible that the CFTC will allow registration to be postponed until Jan. 1, 2013. Clients with questions about this issue should contact an SRZ attorney.

[46] Notwithstanding the effective date, the CFTC has issued no-action relief which allows firms (upon notifying the CFTC) to rely on certain proposed rules which broaden the exemptions available with respect to the new aggregation requirements until the earlier of: (i) 60 days

Effective Dates Related to General Regulation of SDs/MSPs	
Rule	**Effective Date/Compliance Date**
SDs/MSPs must comply with external business conduct rules.	Oct. 12, 2012
SDs/MSPs registered with the SEC or regulated by a prudential regulator must: have in place a risk management program, business continuity plan and disaster recovery plan; monitor position limits; adopt and comply with diligent supervision standards and conflict of interest rules; and designate a Chief Compliance Officer (as well as define the CCO's duties).	Oct. 12, 2012
SDs/MSPs that are neither registered with the SEC nor regulated by a prudential regulator must: have in place a risk management program, business continuity plan and disaster recovery plan; monitor position limits; and adopt and comply with diligent supervision standards and conflict of interest rules.	Dec. 29, 2012
CFTC rules related to customer clearing documentation, timing of acceptance for clearing, clearing member risk management and clearing conflicts become effective for SDs/MSPs and futures commission merchants that are clearing members.	Jan. 1, 2013
SDs/MSPs that are neither registered with the SEC nor regulated by a prudential regulator are required to designate a Chief Compliance Officer (as well as define the CCO's duties).	March 29, 2013

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If you have further questions related to the Definitions Release or any other aspect of Title VII's regulatory framework, or would like additional information, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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after the date on which the CFTC's proposed changes to its aggregation policy are published in the Federal Register (or withdrawn by the CFTC); or (ii) Dec. 31, 2012.

Alert

CFTC Publishes Final Rule on Collateral Segregation for Cleared Swaps

March 8, 2012

> **The Commodity Futures Trading Commission (the "CFTC") issued its final rules requiring futures commission merchants ("FCMs") and derivatives clearing organizations ("DCOs") to segregate collateral posted by customers with respect to cleared swaps (the "Collateral Rules") pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[1] The CFTC adopted the legal segregation with operational commingling model (the "LSOC Model"), which (1) requires FCMs and DCOs to segregate cleared swap customers' collateral on their books and records, and prohibits them from commingling customer collateral with their own funds, but permits FCMs and DCOs to commingle customer collateral in accounts with other cleared swap customers; and (2) restricts a DCO's ability to use non-defaulting customers' collateral to cover a defaulting customer's obligations in the event that a cleared swap customer defaults on its obligations to an FCM which, in turn, defaults on its obligations to the DCO (a "double default"), thereby reducing "fellow-customer risk" (i.e., the risk that a DCO would need to access the collateral of non-defaulting customers to cure an FCM default).**

Private investment fund managers, and the funds that they manage, should be aware of the Collateral Rules because they impact the fellow-customer, operational and investment risks to their collateral. In addition, the Collateral Rules affect the costs of entering into cleared swap transactions. The effective date of the Collateral Rules will be April 9, 2012. All parties, including private fund managers, must comply with the Collateral Rules by Nov. 8, 2012. While implementation may involve considerable operational changes at DCOs and FCMs, it is not expected that most fund managers will have to make significant changes to their current practices in order to comply with the Collateral Rules.

The LSOC Model differs from the existing model that applies to futures (the "Futures Model"). Under the Futures Model, DCOs treat each FCM's customer account on an omnibus basis without differentiating among customers. In the event of a bankruptcy of an FCM due to a double default under the Futures Model, the DCO

[1] Section 724 of the Dodd-Frank Act amended Section 4d of the Commodity Exchange Act (the "CEA"), imposing on each FCM and DCO the following requirements with respect to collateral posted by customers: (1) the FCM must treat customer collateral as belonging to the customer; (2) the FCM must not commingle any customer's collateral with its own property and generally must not use such collateral to margin any other customer's swaps; (3) the DCO must not treat an FCM customer's collateral as belonging to anyone other than the customer; and (4) the FCM and DCO may invest customer collateral only in certain permitted investments.

would be able to access the collateral of non-defaulting customers and defaulting customers posted to the DCO to satisfy any loss in the customer account.[2]

In the case of a bankruptcy of an FCM due to a double default under the LSOC Model, the most significant benefit to customers of the FCM is their protection (assuming that they are a non-defaulting customer) against fellow-customer risk. Where the shortfall is due to a fellow customer's loss that exceeds both the customer's collateral and the FCM's ability to pay, i.e., a double default, the DCO would be able to access only the collateral attributable to defaulting customers to satisfy the loss and not the collateral of non-defaulting customers.[3] In the event of a double default, the adopted model improves on the current Futures Model by not permitting the DCO to access non-defaulting customer collateral in its default "waterfall" of funds to satisfy any losses created from a defaulting customer. In addition, the adopted model improves on the current Futures Model by requiring customer account data to be transmitted to the DCO daily, thereby providing up-to-date information on which to base account transfers and liquidations, and therefore increasing the portability of non-defaulting customers' positions to other FCMs.

The CFTC has acknowledged the limitations of the Collateral Rules in protecting cleared swap customer collateral due to an FCM's bankruptcy with respect to operational risk or investment risk. Under both the LSOC Model and the Futures Model, if the FCM experiences a bankruptcy as a result of corporate financial difficulties unrelated to customer accounts, there will be no shortfall in the customer accounts and each customer's account can be transferred or liquidated in full by the trustee. However, if the shortfall is due to operational risks such as fraud or mismanagement of customer accounts by the FCM, or investment risks resulting from extraordinary losses on permitted investments, customer positions and related collateral at a DCO may be delivered to the trustee of the bankrupt FCM or may be transferred to a solvent FCM, but only to the extent of each customer's pro rata share.

The CFTC may address operational and investment risks in future rulemakings. The CFTC is also considering whether to modify the Futures Model so that futures customers may benefit from protection against fellow-customer risk available to the cleared swap market customers under the LSOC Model.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[2] In addition to the LSOC Model and the Futures Model, the CFTC considered other models, including the "Physical Segregation Model" and the "Legal Segregation with Recourse Model." The Physical Segregation Model requires that each customer's collateral is segregated in separate physical accounts as well as in the FCM's books and records. The Physical Segregation Model is similar to the LSOC Model after an FCM bankruptcy. However, it would be much more expensive to implement this model. In other words, in spite of incurring greater costs, the level of protection for cleared swaps customers would be essentially the same for fellow-customer risks, investment risks, and operational risks. Therefore, the CFTC did not select this model. The Legal Segregation with Recourse Model is similar to the adopted model prior to a default, but after a double default, the DCO would be able to access the collateral of non-defaulting customers if the DCO's own capital and FCM guaranty funds were insufficient. The CFTC also considered allowing each DCO to choose one of the foregoing models rather than mandating any particular one. The CFTC ultimately adopted the LSOC Model because it determined that the model strikes the best balance between costs and risks.

[3] To the extent that the defaulting customers' collateral does not satisfy the loss, the DCO must use its default resources in an order pre-determined by the DCO's rules. The default resources may include guaranty fund contributions, the DCO's own capital, and the DCO's right to call upon its members to contribute additional assets.

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