

**ALERTS**

## Commodities Roundup

**June 7, 2018**

This *Alert* contains a summary of recent Commodity Futures Trading Commission (“CFTC”) and futures exchanges developments.

### **I. CFTC Opens Access to Indian Futures Market for U.S. Customers**

On May 17, 2018, the CFTC issued an order<sup>[1]</sup> to the National Stock Exchange of India (“NSE”), deeming it to have a regulatory regime for its futures brokers that is “comparable” to CFTC requirements. Under this order, NSE members (i.e., clearing members of that exchange) are permitted to accept U.S. customers without having to register as a futures commission merchant with the CFTC. This is a continuation of a CFTC program that has previously provided comparable relief to 12 other jurisdictions.

This action may provide direct access to the Indian futures markets for U.S.-person fund managers and other advisers. NSE members looking to take advantage of this order need to make a filing with the National Futures Association (“NFA”), so U.S. fund managers and advisers looking to enter into relationships with Indian futures brokers should document their confirmation of the NSE member’s status on the NFA’s website.

This order, however, *does not extend to swaps*. U.S.-based fund managers and advisers entering into swaps with Indian counterparties still need to ensure that the swap is compliant with various CFTC requirements (such as certain obligations to report, clear and trade via a CFTC-registered swap execution facility).

## II. Position Limits and Aggregation

The CFTC sets position limits for nine “legacy” futures contracts and requires that the futures exchanges it regulates set limits on other futures contracts. For purposes of calculating position limits, the CFTC also requires the aggregation of “positions in accounts for which any person by power of attorney or otherwise directly or indirectly holds positions or controls trading,” unless the CFTC provides an exemption, such as for indirect holdings where there is no “control.”

Two recent developments have provided some insight into CFTC aggregation requirements:

- A recent CFTC settlement providing certain insight into what constitutes “control” for aggregation; and
- New CFTC interpretive guidance on the effectiveness of certain aggregation exemptions.

### *Glencore CFTC Settlement*

On April 30, 2018, the CFTC reached a \$2-million settlement with Glencore plc for position limit violations concerning two affiliates, Glencore Grain B.V. and Glencore Ltd.[2] Both entities engaged in cotton trading (derivatives and physical trading) as part of Glencore’s overall global cotton business.

Glencore was presumably considering each unit separately for purposes of calculating position limits; however, the CFTC determined that since one individual “oversaw and communicated overarching cotton strategies and policies across Glencore entities” (including the use of futures for hedging purposes), the two entities should have been aggregated. On an aggregated basis, Glencore exceeded the cotton position limit, one of the nine legacy contracts, by 5,000 contracts.

To further exacerbate matters, because Glencore entered into several exchange for physical (“EFP”) transactions between the two Glencore parties, the CFTC also took the position that there was a violation of CFTC Rule 1.38(a), which prohibits noncompetitive trades. While Rule 1.38(a) provides an exception that permits noncompetitive trades when executed in accordance with the written rules of an exchange, ICE Futures U.S. (the exchange where the cotton futures were traded), only permits EFPs between “independently controlled accounts,” which the

CFTC asserts was not the case here (given the one individual's control over the trading of both entities).

While Glencore differs from traditional fund managers in that its entities act as producers and distributors in physical markets (such as cotton), there are still several lessons for managers. Fund managers and other traders that deem different trading units or funds to be disaggregated should consider the CFTC's Glencore factors and consider whether additional separation measures are needed. In particular, they should determine whether they have structures that:

- Centralize management of trading;
- Have unified supervision of traders in different trading units;
- Employ and enforce common trading strategies and policies across different trading units;
- Have information sharing or consolidation for activities and positions across trading units; and
- Permit or facilitate trade-level discussions.

#### *Interpretive Guidance Aggregation*

The CFTC also recently provided interpretive guidance concerning the reliance on aggregation exemptions by fund investors.[3]

As a general rule, an investor that owns 10 percent or more of a fund is required to aggregate the positions of the fund with its own positions. The CFTC, however, provides an aggregation exemption for fund investors, under CFTC Rule 150.4(b)(1), that is available unless (i) the CPO of the fund is exempt from registration pursuant to CFTC Rule 4.13 and (ii) the investor holds a 25 percent or greater interest in the fund.[4]

The rule is silent as to whether an investor relying on Rule 150.4(b)(1)'s exemption from aggregation of positions held *directly* by the fund is nonetheless required to aggregate positions *indirectly* held by the fund (i.e., positions held by portfolio companies owned by the fund, which the investor may indirectly own 10 percent or more of, on the basis of the investor's percentage ownership of the fund). In its recent guidance, however, the CFTC staff stated that, in a Rule 150.4(b)(1) situation, the investor is *not* required to look through its investment in the fund to aggregate the positions of the portfolio company.[5]

This guidance may be helpful for fund managers and large investors in negotiating provisions that would assist the investor with its position limits aggregation requirements.

### **III. Changing Nature of Exchange Disciplinary Sanctions**

In several recent actions brought by the U.S. futures exchange operators, orders resulting from violations of trading rules have resulted in some form of suspension from trading for the trader involved (in addition to fines).

Having a key trading employee prohibited, even temporarily, from trading on behalf of clients could result in significant damage to a manager's investment program and to its clients' portfolios. Fund managers should ensure that traders are well-educated in exchange rules, particularly with respect to rules concerning activities that could be perceived as manipulative trading.

### **IV. CFTC Swap Margin Rule Amendment Proposal**

On May 23, 2018, the CFTC issued a proposed rule ("Proposal")<sup>[6]</sup> to amend certain margin requirements for uncleared swaps ("Margin Rules").<sup>[7]</sup> The Proposal is consistent with a rule proposal issued earlier this year by the Prudential Regulators<sup>[8]</sup> ("QFC Rules")<sup>[9]</sup> and is simply intended to modify the Margin Rules so that swap amendments that are made solely to comply with QFC Rules will not have an adverse impact on the swap counterparties.

Under the Margin Rules, a swap dealer is permitted to calculate margin on an aggregated net basis across uncleared swaps that are executed under the same eligible master netting agreement ("EMNA"). However, a master netting agreement that is amended so as to comply with new QFC Rules requirements concerning cross-default rights would not meet the current definition of EMNA, meaning an amendment to comply with QFC Rules could result in the swap dealer being required to measure its exposure on a gross basis, rather than on an aggregated net basis. The CFTC is proposing to modify the definition of EMNA to cover such amendments. In addition, since an amendment to a "legacy" swap that is exempt from the Margin Rules could cause the swap to lose its legacy status (and lose its exemption from the Margin Rules requirements) the

CFTC is proposing a rule that would permit swaps to keep their legacy status, so long as the amendment was solely entered into in order to comply with the QFC Rules.

Fund managers and other traders that have an EMNA in place with their swap counterparties will also benefit from the Proposal (assuming it is finalized); absent these changes, QFC Rule amendments to swap agreements could have resulted in higher margin requirements for all swap counterparties.

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

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[1] See here.

[2] *In re Glencore Agriculture B.V. and Glencore Ltd.*, Commodity Futures Trading Commission Docket No. 18-12 (April 30, 2018), available here.

[3] CFTC Letter 18-12, available here.

[4] While such 25 percent+ investors are required to aggregate the positions of the fund, another exemption, known as the “independent account controller” exemption, is available in such situations. (The independent account controller exemption still requires aggregation of physically settled contracts during the spot month).

[5] While it seems reasonable to conclude that the same rationale is applicable to a 25 percent+ fund investor relying on the independent account controller exemption (i.e., that a 25 percent+ investor relying on the independent account controller exemption concerning its investment in a CFTC Rule 4.13 fund would also not need to aggregate the positions of a portfolio company held by the fund, other than perhaps physically settled contracts during the spot month), the letter did not directly address this situation.

[6] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 83 FR 23842 (May 23, 2018).

[7] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 636 (Jan. 6, 2016).

[8] “Prudential Regulators” includes the Federal Reserve Board , the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency. Margin rules issued by the Prudential Regulators are applicable to their registrants, while CFTC margin rules are applicable to CFTC registrants that are not registered with a Prudential Regulator.

[9] See 82 FR 42882 (Sep. 12, 2017) (Board of Governors of the Federal Reserve System Rule). See also 82 FR 50228 (Oct. 30, 2017) (Federal Deposit Insurance Corporation Rule). See also 82 FR 56630 (Nov. 29, 2017) (Office of the Comptroller of the Currency Rule).

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