HUNTON& WILLIAMS

Client Alert

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Responding to Questions on Swaps Activity and Commodities Regulation

Recently adopted rules under the Dodd–Frank Act establish a comprehensive new regulatory framework for swaps, including their use and those who use them. We have prepared the below questions and answers to help clarify issues regarding the new rules. The questions and answers are not intended to be comprehensive or to address every situation but, rather, are intended to provide a general overview and explanation of matters related to the regulation of swaps.

Q. **What is a swap?**

A. The legal definition of this term is exhaustive, but generally, a swap is any derivative contract commonly known as a swap. This includes rate and currency swaps, credit default swaps, equity swaps and commodity swaps, which are the categories of swaps considered to be the major swap categories.

Q. **What do swaps have to do with commodities regulation?**

A. There are two kinds of swaps. In the United States, security-based swaps are regulated by the Securities and Exchange Commission ("SEC"). All other swaps are regulated by the Commodity Futures Trading Commission ("CFTC"). CFTC regulates the United States commodity futures and options markets, and certain of its existing rules that govern those instruments apply to swaps as well.

Q. **Who is covered by the new rules?**

A. Generally, the new rules require registration of swap dealers and major swap participants. The new rules also characterize investment funds that trade in swaps as commodity pools and cause their managers or advisers to be commodity pool operators ("CPOs") or commodity trading advisers ("CTAs").

Q. **Who is a swap dealer?**

A. A swap dealer generally is any person that holds itself out as a dealer or makes a market in swaps, among other things, except that the term swap dealer does not include a person that enters into swaps for its own account, either individually or in a fiduciary capacity, but not as part of a regular business. Certain swaps are excluded from consideration, including hedging swaps. Additionally, there is a *de minimis* exemption for swaps entered into during the preceding 12 months and having an aggregate gross notional amount of not more than $8 billion (or $25 million for swaps with government agencies, pension plans, charities and other special entities).

Q. Who is a major swap participant?

A. A major swap participant is a person who maintains a substantial position in any of the major swap categories, excluding hedging swaps except in the case of highly leveraged unregulated financial entities, or whose swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. The new rules use objective numerical criteria to determine whether a substantial position or substantial counterparty exposure exists, but they exclude persons who meet certain conditions. One set of conditions that a person may meet to be excluded requires that the person's swap agreements at no time would permit it to maintain total uncollateralized swap exposure exceeding $100 million and that the person does not maintain swap positions in a notional amount of more than $2 billion in any of the major swap categories described above or more than $4 billion in the aggregate.

Q. What's so bad about having a fund become a commodity pool?

A. Commodity pools are not permitted to elect otherwise available exemptions from the applicable swap clearing requirements. Additionally, commodity pools are covered funds under the proposed Volcker rule, and if this rule is adopted as proposed, banking entities would be required to divest their interests in funds that are commodity pools.

Q. Why does entering into a swap mean a fund is trading and, thus, is a commodity pool?

A. The CFTC interprets its rules expansively and, in an adopting release for its new rules, said that "one swap contract would be enough" for a fund to be trading.

Q. What's the difference between a CPO and a CTA?

A. Generally, CPOs solicit, accept or receive funds, securities or other property from others for the purpose of trading in swaps and other commodity interests. CTAs advise others, for compensation or profit, as to the value of or the advisability of trading in swaps and other commodity interests.

Q. What are the implications of being a CPO or CTA?

A. CPOs and CTAs must register with the National Futures Association ("NFA"). Registrants become members of NFA, which requires compliance with NFA's rules, and are subject to CFTC regulation, including as regards disclosure, reporting, recordkeeping and business conduct. CPOs and CTAs also must, among other things, list their principals and register their associated persons with NFA and have the latter satisfy NFA's proficiency requirements by passing the so-called Series 3 examination.

Q. Are registration exemptions available?

A. CPOs and CTAs that cannot avoid CFTC jurisdiction by keeping their commodity pools from trading in swaps and other commodity interests may be able to qualify for certain registration exemptions. For instance, a *de minimis* exemption from CPO registration, together with a related CTA registration exemption for registered (or excluded or exempt) investment advisers providing incidental advice and not holding themselves out as CTAs, is available for private pools offered to sophisticated investors and not marketed as a vehicle for trading in commodity interests if the aggregate initial margin, premiums and minimum retail forex security deposits for the pool's commodity interest positions do not exceed 5 percent of the pool's liquidation value or if the aggregate net value of the pool's commodity interest positions do not exceed 100 percent of the pool's liquidation value. Registered investment companies, insurance companies, banks and pension plans also benefit from CPO registration exemptions with respect to certain activities.

Q. Can the obligations of registered CPOs and CTAs be minimized?

A. Exemptions from certain disclosure, reporting and recordkeeping requirements are available to CPOs and CTAs for pools that satisfy certain conditions based on their participants, on the manner in which their securities are offered or listed for trading or on the amount and nature of their commodity interest trading, among other things, to make CFTC requirements consistent with SEC requirements. Many exemptions available to CPOs and CTAs, however, require that a notice be filed with NFA.

Q. What are the consequences of a failure to comply?

A. CFTC has, like SEC, substantial enforcement power with respect to violations of the laws over which it has jurisdiction, including their anti-fraud and anti-manipulation provisions. Among other things, CFTC may suspend or revoke the registration of a person who fails to comply, prohibit such a person from trading or doing business with registered entities, impose civil money penalties, require restitution and seek fines or imprisonment for criminal violations. Additionally, a private right or action exists against those who violate the laws over which CFTC has jurisdiction or who willfully aid, abet, counsel, induce or procure a violation of those laws.

Q. What other action can be taken?

A. Real estate investment trusts ("REITs") and other funds may consider whether to file no-action letters with CFTC requesting confirmation that CFTC's staff would not recommend enforcement action if they conduct only limited commodity pool activities and do not register a CPO or CTA in respect of those activities. In 2000, mortgage REITs that agreed to restrict commodity interest trading to hedging transactions in interest rate futures and options, to limit income from those transactions to 5 percent of their gross income and to limit the initial margin and option premiums on those transactions to not more than one percent 1 percent of the fair market value of their total assets received such confirmations from CFTC's staff in response to their no-action request letters.

Q. What is the registration, filing and qualification deadline?

A. CPOs and CTAs of funds that become commodity pools solely because of their swaps will be required to register or file notice of exemption on or before October 12, 2012. We understand that NFA historically has declared complete applications for registration effective within a few business days of receipt, but as the above deadline approaches, a longer wait may result from the volume of applications. Filing a no-action letter request in lieu of an application for registration might not satisfy CFTC.

Hunton & Williams LLP attorneys are available to furnish more information on swaps activity and CFTC regulation under the Dodd-Frank Act. If you would like to receive more information, please contact one of the following attorneys:

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