

WHAT IS THE BASIC MINIMUM NECESSARY TO KEEP SMALL MARKET PARTICIPANTS IN COMPLIANCE WITH CFTC REQUIREMENTS?

PRESENTED BY

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COMMON CFTC COMPLIANCE QUESTIONS OF SMALL ENTITIES

- I am not a financial trader on Wall Street; so, does the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) apply to me?
- Are there any exemptions?

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COMMON CFTC COMPLIANCE QUESTIONS OF SMALL ENTITIES

- Am I an End-User?
- Am I an Eligible Contract Participant?
- Is this agreement a swap?
- Does this agreement qualify as an excluded forward contract?
- Does this agreement qualify as an exempt commodity trade option?

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COMMON CFTC COMPLIANCE QUESTIONS OF SMALL ENTITIES

- What reporting obligations apply to me?
- What recordkeeping obligations apply to me?

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DODD-FRANK ACT

- The Dodd-Frank Act generally grants the Commodity Futures Trading Commission (“CFTC”) jurisdiction based on the type of transaction conducted (*i.e.*, a swap/option).
- While some entities (*e.g.*, Swap Dealers and Major Swap Participants) are regulated more heavily than others, there is no outright exemption in the Dodd-Frank Act for small entities who engage in swap transactions.

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SWAP

- The Dodd-Frank Act broadly defines a swap.
- Among other things, it includes a put, call, cap, floor, collar or similar option of any kind.
- As a result, CFTC has interpreted a “swap” to include commodity trade options, such as call options on electric energy which are common in the energy industry.

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ELIGIBLE CONTRACT PARTICIPANT

- Subject to certain limited exceptions, it is unlawful to trade a swap off a regulated exchange (*e.g.*, a Swap Execution Facility or Designated Contract Market) unless you are an Eligible Contract Participant (“ECP”).
- Therefore, a critically important initial step in any Dodd-Frank compliance assessment for a small entity is to determine whether or not the entity falls within the definition of an ECP.

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ECP CRITERIA

- Section 1a(18) of the Commodity Exchange Act (“CEA”) contains detailed criteria that should be read in their entirety to determine whether an entity qualifies for ECP status.
- Generally, the entity must be trading for its own account (not on behalf of others).
- If the entity is a governmental utility, it must own and invest on a discretionary basis \$50,000,000 or more in investments.

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ECP CRITERIA

- If it is a corporation, partnership, proprietorship, organization, trust, or other entity:
 - it must have total assets exceeding \$10,000,000, the obligations of which under an agreement, contract, or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by a qualified entity; or
 - it must have a net worth exceeding \$1,000,000 and enter into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business.

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FORWARD CONTRACT EXCLUSION

- Forward contracts are excluded expressly from the definition of a swap.
- Specifically, the Dodd-Frank Act excluded the “sale of a nonfinancial commodity ... for deferred shipment or delivery, so long as the transaction is intended to be physically settled.”
- CFTC interpreted this to mean that there must be a binding delivery obligation in the contract.

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BONA FIDE TERMINATION RIGHTS

- A failure to deliver as a result of the exercise of a “bona fide termination right” does not make an otherwise binding delivery obligation non-binding.
- CFTC stated that the termination right must be triggered by something not expected by the parties at the time they entered into the contract.
- Examples include force majeure provisions and termination rights triggered by events of default, including a counterparty default, insolvency, or other inability to perform.

BOOK-OUTS

- To maintain the forward contract exclusion, an oral book-out must be followed in a commercially reasonable timeframe by a confirmation in written or electronic form.
- Confirmation records must be kept proving this requirement was met.

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COMMODITY TRADE OPTION EXEMPTION

- This exemption can be invoked if the following criteria are met:
 - (1) the offeror is an ECP or a producer, processor, commercial user, or merchant of the commodity that is the subject of the transaction and is entering into the transaction solely for purposes related to its business as such a producer, processor, commercial user, or merchant of the commodity;
 - (2) the offeree is a producer, processor, commercial user or merchant of the commodity that is the subject of the transaction and is entering into the transaction solely for purposes related to its business as such a producer, processor, commercial user, or merchant of the commodity; and
 - (3) the trade option must be intended by both parties to be physically settled, so that if exercised, the option would result in the sale of an exempt or agricultural commodity for immediate (spot) or deferred (forward) shipment or delivery.
- Some regulatory obligations continue to apply, such as recordkeeping, reporting, and restrictions on fraud and market manipulation.



FORWARD CONTRACTS WITH EMBEDDED OPTIONALITY

- Many contracts include optionality regarding the amount of the commodity to be delivered.
- So long as the contract requires delivery of at least some non-nominal, fixed volume of a non-financial commodity, CFTC stated that the predominant feature of contract remains actual delivery.
- It cited, for example, a forward contract requiring delivery of 10,000 bushels of wheat that includes an option for an additional 5,000 bushels of wheat.



CFTC 7-PRONG TEST

- CFTC developed a 7-prong test for determining when a forward contract would continue to qualify for the forward contract exclusion even though it contains an embedded volumetric option.
- This test was revised recently.



RECENTLY-REVISED

CFTC TEST

1. The embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract;
2. The predominant feature of the agreement, contract, or transaction is actual delivery;
3. The embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded;

RECENTLY-REVISED

CFTC TEST

4. The seller of a nonfinancial commodity underlying the agreement, contract, or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction to deliver the underlying nonfinancial commodity if the embedded volumetric optionality is exercised;
5. The buyer of a nonfinancial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to take delivery of the underlying nonfinancial commodity if the embedded volumetric optionality is exercised;
6. Both parties are commercial parties; and

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RECENTLY-REVISED CFTC TEST

7. The embedded volumetric optionality is primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity.

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OTHER CFTC EXEMPTIONS

- CFTC issued individual orders exempting some particular types of transactions from regulation as swaps, including:
 - certain transactions in organized electric markets operated by Regional Transmission Organizations (“RTOs”)/Independent System Operators (“ISOs”); and
 - certain transactions between qualifying governmental utilities, Indian tribes and/or electric cooperatives that would not have been entered into, but for the qualifying entity’s need to manage supply and/or price risks arising from its existing or anticipated public service obligations to physically generate, transmit, and/or deliver electric energy service to customers.

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END-USER EXCEPTION TO CLEARING REQUIREMENT

- The Dodd-Frank Act makes it unlawful for any person to engage in a swap, which CFTC determines must be cleared, unless the person submits the swap for clearing to a derivatives clearing organization.
- There is an exception to this general requirement, however, enabling a person to elect not to clear a swap when that person is using the swap to hedge or mitigate commercial risk.
- This exception is commonly referred to as the “end-user” exception.



PROHIBITION ON ABUSE OF END-USER EXCEPTION

- To qualify for the end-user exception, a person must actually be using the swap to hedge or mitigate a commercial risk, and cannot instead be using the swap for speculation, investing or trading.
- A penalty potentially could be imposed for abuse of the end-user exception.



SPECULATING, TRADING AND INVESTING

- These types of swaps are executed primarily for the purpose of taking an outright view on market direction or to obtain appreciation in the value of the swap position itself, not to hedge or mitigate an underlying commercial risk such as a risk of future increase in price of fuel needed to generate electricity.



SPECULATING, TRADING AND INVESTING

- Trading means entering and exiting swap positions for purposes unrelated to hedging or mitigating commercial risks incurred in normal course of business.
- CFTC indicated that a swap position held primarily for purpose of generating profits directly upon the close out of the swap is an example of speculation or investing.



SWAP REPORTING REQUIREMENTS

- Details about the primary economic terms of a swap transaction must be reported quickly to a Swap Data Repository (“SDR”).
- CFTC established a reporting hierarchy that places the obligation to report swap transactions first and foremost on Swap Dealers (“SDs”), Major Swap Participants (“MSPs”), and financial entities.

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SWAP REPORTING REQUIREMENTS

- End-user bears reporting obligation only when the swap transaction is conducted with another end-user that is not an SD, MSP, or financial entity.
- In that situation, the two end-users must agree, amongst themselves, which one will report and that reporting agreement must be a “term” of the swap transaction.
- **CAVEAT:** When one of the two end-user counterparties is not a U.S. person, CFTC imposes the reporting obligation on U.S. person.



LEGAL ENTITY IDENTIFIER

- Even if you are not the swap reporting party, you must obtain a “legal entity identifier” and provide it to the reporting party to include in its report to the SDR.

REPORTING OF COMMODITY TRADE OPTIONS

- Rather than requiring that reporting of commodity trade options always be done immediately on a transaction-by-transaction basis to an SDR, CFTC established a lighter-handed regulatory framework enabling end-users, which are not SDs or MSPs, to report their transactions with other end-users annually on a Form TO.
- To further ease regulatory burdens on end-users, CFTC is now considering a proposed amendment to its regulation that would eliminate even this annual reporting requirement.

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RECORDKEEPING REQUIREMENTS

- The end-user would still have to comply with swap recordkeeping requirements in §45.2 of the CFTC's regulations, including recordkeeping for its commodity trade option transactions (which CFTC views as falling within the definition of swap).

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RECORDKEEPING REQUIREMENTS

- Specifically, § 45.2(b) states in pertinent part with respect to Non-SDs/MSPs:

§45.2 Swap recordkeeping.

- (b) *Recordkeeping by non-SD/MSP counterparties.* All non-SD/MSP counterparties subject to the jurisdiction of the Commission shall keep full, complete, and systematic records, together with all pertinent data and memoranda, with respect to each swap in which they are a counterparty, including, without limitation, all records demonstrating that they are entitled, with respect to any swap, to elect the clearing requirement exception in CEA section 2(h)(7).
- (c) *Record retention.* All records required to be kept pursuant to this section shall be retained with respect to each swap throughout the life of the swap and for a period of at least five years following the final termination of the swap.
- (d) *Retention form.* Records required to be kept pursuant to this section must be kept as required by paragraph (d)(1) or (2) of this section, as applicable.

* * *

- (2) Records required to be kept by non-SD/MSP counterparties may be kept in either electronic or paper form, so long as they are retrievable, and information in them is reportable, as required by this section.

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RECORDKEEPING REQUIREMENTS

(e) *Record retrievability.* Records required to be kept by swap execution facilities, designated contract markets, derivatives clearing organizations, or swap counterparties pursuant to this section shall be retrievable as provided in paragraphs (e)(1) and (2) of this section, as applicable.

* * *

(2) Each record required by this section or any other section of the CEA to be kept by a non-SD/MSP counterparty shall be retrievable by that counterparty within five business days throughout the period during which it is required to be kept.

* * *

(h) *Record inspection.* All records required to be kept pursuant to this section ... by any non-SD/MSP counterparty subject to the jurisdiction of the Commission shall be open to inspection upon request by any representative of the Commission, the United States Department of Justice, or the Securities and Exchange Commission, or by any representative of a prudential regulator as authorized by the Commission. Copies of all such records shall be provided, at the expense of the entity or person required to keep the record, to any representative of the Commission upon request.... Copies of records required to be kept by any non-SD/MSP counterparty subject to the jurisdiction of the Commission that is not a Commission registrant shall be provided in the form, whether electronic or paper, in which the records are kept.

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REPORTING OF ELECTION OF END-USER EXCEPTION

- When a counterparty elects the end-user exception, the “reporting counterparty” (as determined per hierarchy described earlier) must notify an SDR of the election of the exception and the identity of the electing counterparty to the swap.



REPORTING OF ELECTION OF END-USER EXCEPTION

- Additional information must either be provided annually in anticipation of electing the end-user exception or on a transaction-by-transaction basis, such as:
 - whether the electing counterparty is a financial entity;
 - whether the swap or swaps for which the electing counterparty is electing the exception are used by the electing counterparty to hedge or mitigate commercial risk;

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REPORTING OF ELECTION OF END-USER EXCEPTION

- how the electing counterparty generally meets its financial obligations associated with entering into noncleared swaps (*e.g.*, credit support agreement, pledged or segregated assets, third-party guarantee, available financial resources);
- whether the electing counterparty is an issuer of securities registered or required to file reports under certain sections of the Securities Exchange Act of 1934 and, if so, the relevant SEC Central Index Key number for that counterparty; and

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REPORTING OF ELECTION OF END-USER EXCEPTION

- whether an appropriate committee of the electing counterparty's board of directors (or equivalent body) has reviewed and approved the decision to enter into swaps that are exempt from the clearing requirement.

SPECIAL ENTITIES

- The Dodd-Frank Act and CFTC regulations include provisions to protect a “Special Entity” from abuse, particularly by SDs.
- A Special Entity is defined to include, among other governmental entities, a city, county, municipality or other political subdivision of a state.
- Governmental utilities (i.e., “public power” entities) generally fall within this definition.

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SPECIAL ENTITIES

- Subject to certain safe harbor exclusions, CFTC's regulations require an SD to take steps to show that a swap is suitable for a particular counterparty and, in the case of a Special Entity, that the swap is in the Special Entity's "best interest."
- An SD can be relieved of the "best interest" requirement, however, when a Special Entity has its own Qualified Independent Representative (QIR) advising it.

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QIR

- QIR must be “independent” from the SD. Internal manager or employee, with sufficient knowledge/experience, can potentially serve as your QIR under CFTC’s rule.
- You must have written QIR policies and procedures meeting specific CFTC requirements and the QIR must be legally obligated to comply with these requirements by agreement, condition of employment, law, rule, regulation or other enforceable duty.

PROHIBITION OF FRAUD AND MARKET MANIPULATION

- Although a forward contract that is intended to be physically settled falls outside the statutory definition of a swap (as well as a futures contract), the CEA does grant CFTC some additional authority over sales of “any commodity in interstate commerce,” including authority to prohibit fraud and market manipulation.



PROHIBITION OF MARKET MANIPULATION

- For example, CEA prohibits manipulation not only in connection with futures and swap transactions, but also in connection with the “sale of any commodity in interstate commerce.”



PROHIBITION OF FALSE REPORTING

- It is unlawful to deliver through the mails or interstate commerce, by any means of communication whatsoever, a false or misleading or inaccurate report concerning market information or conditions that affect or tend to affect **the price of any commodity in interstate commerce**, knowing, or acting in reckless disregard of the fact that such report is false, misleading or inaccurate.



PROHIBITION OF FRAUDULENT TRANSACTIONS

- It is unlawful for any person, in connection with any contract for the sale of “any commodity in interstate commerce,” a futures contract, or a swap, that is made, or to be made, for or on behalf of, or with, any other person, other than on or subject to the rules of a Designated Contract Market:
 - to cheat or defraud or attempt to cheat or defraud the other person;



PROHIBITION OF FRAUDULENT TRANSACTIONS

- willfully make or cause to be made to the other person any false report or statement or willfully to enter or cause to be entered for the other person any false record; or
- willfully deceive or attempt to deceive the other person by any means whatsoever in regard to any order or contract or the disposition or execution of any order or contract.



PROHIBITION OF FICTITIOUS TRANSACTIONS AND FALSE PRICE REPORTING

- A person is also prohibited from:
 - offering to enter into, entering into, or confirming the execution of a transaction involving the purchase or sale of any commodity for future delivery (or any option on such transaction or option on a commodity) or a swap when the transaction is: (i) what is commonly known as a wash sale or accommodation trade; (ii) a fictitious sale; or (iii) used to cause any price reported, registered or recorded that is not a true and bona fide price;
 - entering into a swap knowing, or acting in reckless disregard of the fact, that its counterparty will use the swap as part of a device, scheme or artifice to defraud any third party; or



PROHIBITION OF FALSE REPORTING

- making any false or misleading statements of material fact to the CFTC relating to a swap, contract of sale for a commodity in interstate commerce or for future delivery subject to the rules of any registered entity, or omitting any material fact that is necessary to make any statement of material fact made not misleading in any material respect if the person knew, or reasonably should have known, the statement to be false or misleading.



PROHIBITION OF DISRUPTIVE TRADING PRACTICES

- Disruptive trading practices are prohibited, including:
 - violating bids and offers (*i.e.*, buying a contract at a price that is higher than the lowest available offer price and/or selling a contract at a price that is lower than the highest available bid price);
 - intentionally or recklessly disregarding the orderly execution of transactions during the closing period of a market; or
 - spoofing (*i.e.*, bidding and offering with intent to cancel bid or offer before execution).



SOME HALLMARKS OF A GOOD COMPLIANCE PROGRAM

- Culture, emanating from top down, that encourages compliance;
- Active support and oversight from senior management, including sufficient funding for compliance program;
- Inventory of all compliance obligations;
- Assignment of responsibility to specific individuals within the organization for compliance program and providing direct access to governing authority (such as Risk Management Committee and Board of Directors);
- Tracking of completion of compliance obligations;



SOME HALLMARKS OF A GOOD COMPLIANCE PROGRAM

- Compliance training and ongoing communications;
- Exercise of due diligence to prevent and detect violations, including monitoring and auditing;
- Publicized system, including mechanisms that allow for anonymity or confidentially, whereby employees may report or seek guidance regarding potential or actual violations without fear of retaliation;



SOME HALLMARKS OF A GOOD COMPLIANCE PROGRAM

- Incentives and disciplinary measures to promote and enforce compliance;
- Promptly responding to and remedying a detected violation and making any necessary modification to compliance program to prevent recurrence;
- Process for self-reporting violations to FERC or CFTC and cooperating with investigations; and
- Periodic evaluations of effectiveness of the organization's compliance program.



QUESTIONS?

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