

# Derivatives Alert

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## CFTC Extends Phase 5 Compliance Date for Its Initial Margin Rules and Proposes More Regulatory Flexibility for Non-US Commodity Pool Operators

On May 28, 2020, the Commodity Futures Trading Commission (CFTC or Commission) unanimously approved an interim final rule extending the Phase 5 compliance date for the Commission's initial margin rules ([Interim Final Rule](#)) and a proposed rule aimed at providing more flexibility for non-U.S. commodity pool operators (CPOs) to claim exemption from registration with respect to commodity pools for non-U.S. investors ([Proposed Rule](#)).

The Interim Final Rule will become effective upon publication in the Federal Register, and the public comment period will be open for 60 days after publication for each of the Interim Final Rule and the Proposed Rule.

Both rules reflect the Commission's continuing inclination to provide derivatives market participants flexibility during a time of increased economic uncertainty.

### Deferral of Phase 5 Compliance Date for Initial Margin Rules

The Interim Final Rule<sup>1</sup> will extend the September 1, 2020, Phase 5 compliance deadline for the CFTC's initial margin requirements for uncleared swaps by one year to September 1, 2021, in response to the operational challenges for compliance caused by the COVID-19 pandemic.<sup>2</sup> Under the revised schedule, for swap dealers that are registered with the CFTC and their covered counterparties with swaps portfolios ranging from \$50 billion to \$750 billion in average daily aggregate notional amount (AANA), the compliance date will now be September 1, 2021.

<sup>1</sup> The Administrative Procedure Act generally requires agencies to publish a notice of proposed rulemaking and provide an opportunity for public comment before issuing a rule, but agencies can issue final rules without notice and comment (so-called interim final rules) upon a finding of "good cause." 5 U.S.C. § 553(b)(B). For the Interim Final Rule, the Commission found good cause to forgo notice and comment procedures because the need for relief is "immediate" to obviate market participants' need to prepare for compliance with the initial margin requirements while experiencing diminished operational capacity due to the COVID-19 pandemic.

<sup>2</sup> The extension is consistent with the recent revision by the Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions of the implementation schedule for margin requirements for noncentrally cleared derivatives. See Basel Committee and Banking Supervision and Board of the International Organization of Securities Commissions, [Margin Requirements for Non-Centrally Cleared Derivatives](#) (Apr. 2020).

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Two months ago, the Commission added a sixth phase of initial margin rules compliance and provided an additional year for smaller entities with an AANA between \$8 billion and \$50 billion by extending their compliance date to September 1, 2021.<sup>3</sup> Although the Interim Final Rule does not address the Phase 6 compliance date, which will now overlap with the Phase 5 compliance date, the Commission stated that it intends to issue a proposed rule with respect to the final compliance phase “in the near term.”<sup>4</sup>

For additional background on the CFTC’s initial margin requirements, please see our previous client alerts:

- [“Prudential Regulators Finalize Margin Requirements for Non-Cleared Swaps,”](#) November 2, 2015; and
- [“Final Phases of Initial Margin Requirements for Uncleared Swaps Expected To Spark Additional Margin Compliance Efforts,”](#) July 26, 2018.

## More Flexibility for Non-US CPOs To Claim Exemption From Registration

Section 4m(1) of the Commodity Exchange Act (CEA) generally requires a person that meets the definition of a “commodity pool operator” under CEA Section 1a(11) to register as such with the Commission.<sup>5</sup> At the same time, the CEA authorizes the Commission to include within, or exclude from, the CPO definition any person by rule or regulation if the Commission determines that such rule or regulation will effectuate the purposes of the CEA — thus exempting such person from the CPO registration requirement.<sup>6</sup>

CFTC Rule 3.10(c) provides one such exemption for CPOs that are located outside the United States and trade commodity interests only on behalf of non-U.S. persons (the 3.10 Exemption). Under the current 3.10 Exemption, however, a non-U.S. CPO cannot rely on it while also relying on another exemption or an exclusion for the operation of other commodity pools, or if regis-

tered as a CPO with respect to the operation of other commodity pools. As a result, a non-U.S. CPO that operates a combination of non-U.S. and U.S. commodity pools currently is required to either register all of its offshore pools with the Commission as if those pools were onshore pools, find another available exemption from registration or claim a regulatory exclusion with respect to those offshore pools.

As the Commission explains, the 3.10 Exemption is “intended to focus the Commission’s resources on protecting U.S. participants” by obviating the CFTC’s need to conduct oversight of non-U.S. CPOs whose pools have no U.S. investors. But the current restrictions on the 3.10 Exemption mean that the Commission is effectively required to oversee the operations of offshore pools that are located outside the United States and have no domestic participants.

The Proposed Rule aims to address that issue by providing more flexibility for non-U.S. CPOs in claiming the 3.10 Exemption. To that end, the Commission proposed three amendments to Rule 3.10(c):

- Allow non-U.S. CPOs to claim the Rule 3.10(c) exemption on a pool-by-pool basis and concurrently with other available relief from the CPO registration requirement.
  - The Proposed Rule would specify that the availability of the 3.10 Exemption is determined by whether all of the participants in a particular offshore pool, rather than the participants of all of the pools run by the non-U.S. CPO, are located outside the United States.
  - The Proposed Rule would also explicitly provide that claiming the 3.10 Exemption will not affect the ability of the non-U.S. CPO to claim other registration exemptions or regulatory exclusions with respect to other pools it operates that are not covered by the 3.10 Exemption.
- Provide a safe harbor that would allow a non-U.S. CPO to rely on the 3.10 Exemption even if the non-U.S. CPO cannot represent with certainty that the pools for which the 3.10 Exemption is claimed have no U.S. participants. To be eligible for the proposed safe harbor, the non-U.S. CPO would have to satisfy the following five conditions:
  - The offshore pool’s offering materials and any underwriting or distribution agreements include clear, written prohibitions on the offshore pool’s offering to participants located in the United States and on U.S. ownership of the offshore pool’s participation units;
  - The offshore pool’s documents and offering materials: (a) are reasonably designed to preclude persons located in the United States from participating, and (b) include mecha-

<sup>3</sup> See [Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants](#), 85 Fed. Reg. 19878 (Apr. 9, 2020).

<sup>4</sup> The Commission noted that without an extension of the final compliance phase, approximately 700 entities would come into the scope of the initial margin requirements simultaneously on September 1, 2021.

<sup>5</sup> See 7 U.S.C. § 6m(1). A CPO is defined as any person “engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests,” which include futures, options, swaps, and certain leveraged foreign currency or retail commodity transactions. *Id.* § 1a(11)(A). A “commodity pool” is defined as “any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests.” *Id.* § 1a(10)(A).

<sup>6</sup> See *id.* § 1a(11)(B).

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nisms reasonably designed to enable the CPO to exclude any persons located in the United States who attempt to participate in the offshore pool notwithstanding those prohibitions;

- The non-U.S. CPO exclusively uses non-U.S. intermediaries<sup>7</sup> for the distribution of participations in the offshore pool;
- The non-U.S. CPO uses reasonable investor due diligence methods at the time of sale to preclude persons located in the United States from participating in the offshore pool; and
- The offshore pool's participation units are directed and distributed to participants outside the United States, including by means of listing and trading such units on secondary markets organized and operated outside of the United States, and in which the non-U.S. CPO has reasonably determined participation by persons located in the United States is unlikely.

The Commission also noted that it would expect non-U.S. CPOs claiming the 3.10 Exemption to maintain adequate documentation to demonstrate compliance with the terms of the safe harbor.

- Allow a non-U.S. CPO to receive capital contributions from its U.S. controlling affiliate for such CPO's offshore pools as part of the initial capitalization without affecting the non-U.S. CPO's ability to claim the 3.10 Exemption.
  - In this context, the Commission proposed to define "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract, or otherwise."

- The Commission reasoned that a U.S. controlling affiliate's initial investment in a non-U.S. CPO's offshore pool does not raise the same customer protection concerns as similar investment by an unaffiliated U.S. person because the controlling affiliate would be well-positioned to obtain a meaningful degree of protection and transparency with respect to its investment.
- At the same time, the Commission proposed to limit the exception for contributions from a U.S. controlling affiliate to those made at or near a pool's inception, although the contributed capital may remain in the offshore pool for the duration of its operations.
- Finally, the proposed exception for U.S. controlling affiliates also includes anti-evasion provisions and would prohibit capital contributions by a person subject to a statutory disqualification; ongoing registration suspension; or bar, prohibition on acting as a principal or trading ban with respect to participating in the U.S. commodity interest markets.

All commissioners voted in favor of the Proposed Rule, and CFTC Chairman Heath Tarbert noted that the Proposed Rule, if adopted, "would provide much-needed regulatory flexibility for non-U.S. CPOs operating offshore commodity pools, without compromising the CFTC's mission to protect U.S. investors."<sup>8</sup>

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<sup>7</sup> The Proposed Rule notes that a non-U.S. intermediary would include a non-U.S. branch or office of a U.S. entity, or a non-U.S. affiliate of a U.S. entity, provided that the distribution takes place exclusively outside of the United States.

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<sup>8</sup> [Statement of Chairman Heath P. Tarbert in Support of Amending the Registration Exemption for Foreign CPOs](#) (May 28, 2020).