

# Derivatives Alert

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## House Bill to Shake Up CFTC Rulemakings

Less than two weeks into the new congressional session, the U.S. House of Representatives passed by a vote of 239 to 182 the Commodity End-User Relief Act<sup>1</sup> (the Bill or House Bill), marking the first step by the new post-election Congress to pare down elements of the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act (Dodd-Frank). The Bill would reauthorize the Commodity Futures Trading Commission (CFTC or Commission) for five years, at an annual budget level that would be unchanged from last year.<sup>2</sup> Many key provisions in the House Bill, including some added on the House floor to versions of the legislation that had passed the House in the prior Congress, would affect ongoing CFTC rulemakings.<sup>3</sup> We discuss these provisions below. It is too soon to tell what the fate of these provisions would be in any Senate consideration of this measure. But the House Bill does illustrate that the post-election environment, including the impending resignation of CFTC Chairman Timothy Massad,<sup>4</sup> will likely have considerable impact on significant sets of rules on the docket at the CFTC.

<sup>1</sup> H.R. 238, 115th Cong. (2017).

<sup>2</sup> The House Bill would authorize a \$250 million annual budget over the next five years for the CFTC. See Consolidated Appropriations Act, 2016, Pub. L. 114-113, 129 Stat. 2242, 2271 (Dec. 18, 2015). The CFTC had asked for a budget of \$330 million for Fiscal Year 2017, and President Barack Obama had sought to double the agency's budget by 2021. See Commodity Futures Trading Commission: President's Budget – Fiscal Year 2017 2 (Feb. 2016), <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/cftcbudget2017.pdf>; see also Stewart Bishop, *Obama Wants SEC, CFTC Funding Doubled by 2021*, *Law360* (Feb. 8, 2016, 8:00 p.m.), <https://www.law360.com/articles/756718/obama-wants-sec-cftc-funding-doubled-by-2021>. Republican members of the Agriculture Subcommittee of the House Committee on Appropriations criticized the agency's request, citing a U.S. Government Accountability Office report finding that the CFTC had improperly recorded certain leasing costs. See Carmen Germaine, *CFTC Chair Faces Budget Scrutiny After Accounting Errors*, *Law360* (Feb. 10, 2016, 9:53 p.m.), <https://www.law360.com/articles/757209/cftc-chair-faces-budget-scrutiny-after-accounting-errors>.

<sup>3</sup> The proposed rulemakings addressed by this client alert were proposed or repropoed in 2016. Other CFTC proposed rulemakings in 2016 included: Capital Requirements of Swap Dealers and Major Swap Participants, 81 Fed. Reg. 91,252 (proposed Dec. 16, 2016) (to be codified at 17 C.F.R. pts. 1, 23 & 140), Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 Fed. Reg. 71,946 (proposed Oct. 18, 2016) (to be codified at 17 C.F.R. pts. 1 & 23), Whistleblower Awards Process, 81 Fed. Reg. 59,551 (proposed Aug. 30, 2016) (to be codified at 17 C.F.R. pt. 165), and Exemption From Registration for Certain Foreign Persons, 81 Fed. Reg. 51,824 (proposed Aug. 5, 2016) (to be codified at 17 C.F.R. pt. 3). For more information on the proposed rule regarding the application of certain CFTC requirements to cross-border transactions, see our Oct. 21, 2016, Skadden [client alert](#). The CFTC most recently proposed amendments to the swap data access provisions in Part 49 and certain other provisions and separately proposed amendments to the registration provisions in Part 3 and the rules relating to review of exchange disciplinary, access denial or other adverse actions in Part 9. Both proposed amendments are available on the [CFTC website](#). The CFTC also recently proposed amendments to the recordkeeping requirements in CFTC Rule 1.31. The proposed amendment is available on the [CFTC website](#).

<sup>4</sup> Although Chairman Massad's resignation as chairman will be effective on January 20, 2017, he will remain a commissioner for several weeks afterward to handle administrative matters. Press Release, *CFTC Chairman Timothy Massad Announces Resignation as Chairman*, CFTC (Jan. 3, 2017), <http://www.cftc.gov/PressRoom/PressReleases/pr7507-17>.

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**Position Limits.** The House Bill would remove the Dodd-Frank provisions that the CFTC interpreted to be a statutory mandate to impose speculative position limits for physical commodity futures and options contracts and economically equivalent swaps.<sup>5</sup> In addition, the House Bill would expand the Dodd-Frank definition of *bona fide* hedging to explicitly cover anticipatory hedging and risk management, thereby making the definition more in line with the broader pre-Dodd-Frank concept of *bona fide* hedging.<sup>6</sup> The CFTC has just recently issued and requested comment on a reproposal of its position limits rules. Given the House Bill's repeal of the Dodd-Frank "mandate" provisions, it is unclear whether the CFTC will take a fresh look at the position limit reproposal it has issued. But it is likely that any final rule the CFTC will adopt in this area will at least take into account the House Bill's expanded *bona fide* hedging definition.<sup>7</sup>

**End-User Amendments.** The House Bill would expand end-user relief from key Dodd-Frank swap requirements, such as swap clearing requirements and non-cleared margin requirements. The House Bill would amend the Commodity Exchange Act (CEA) definition of "swap" to exclude physically settled commodity forward contracts and contracts with volumetric optionality.<sup>8</sup> Currently, end-users seeking relief with respect to these contracts rely on CFTC interpretations of the "swap" definition, such as a 2015 interpretation that established a seven-part test to determine whether certain physical contracts with volumetric optionality fall under the forward exclusion.<sup>9</sup> The House Bill also would amend the CEA definition of "financial entity" to expressly exclude commercial end-users, making it easier to qualify for non-cleared margin exemptions.<sup>10</sup>

**Requests for Intellectual Property.** If enacted, the House Bill would preclude one of the most contentious proposals in the CFTC's current automated trading proposal from becoming law. The CFTC's automated trading proposal includes a regulation that would allow the Commission to obtain proprietary algorithmic trading source code through a "special call," which is a type of non-subpoena, regulatory information demand that would be issued if approved by the Commission, not the staff,

and administered through a process operated by the director of the Division of Market Oversight.<sup>11</sup> The proposed regulation has been criticized as providing the Commission with an unconstitutional "end-run" around the subpoena process that subverts firms' ability to protect their intellectual property.<sup>12</sup> The House Bill would prohibit the CFTC from compelling firms to produce algorithmic trading source code or other intellectual property absent a Commission subpoena.<sup>13</sup>

**FCM Residual Interest Requirements.** The House Bill would require that any CFTC futures commission merchant (FCM) residual interest requirements can be met as of the business day following a trade.<sup>14</sup> Current CFTC regulations require FCMs to maintain a residual interest, or a sufficient amount of their own funds, in undermargined customer segregated accounts by a deadline of 6:00 p.m. Eastern time on the business day following the FCM's calculations.<sup>15</sup> The 6:00 p.m. deadline has been controversial, with concerns that the CFTC could amend the deadline to an earlier time of day.<sup>16</sup> If enacted, the House Bill would restrict the CFTC's ability to set a shorter deadline.

**Ownership and Control Reporting.** The House Bill would relax the CFTC's current ownership and control reporting requirements. The bill would delay enforcement of noncompliance with the CFTC's ownership and control reporting rules until the Commission increases the reportable trading volume level to at least 300 contracts (instead of the current 50-contract level). The bill also would provide that reporting entities are not required to report natural person controller data or furnish data in violation of foreign privacy laws, as current CFTC rules require.<sup>17</sup>

**Interaffiliate Transactions.** The House Bill would amend the CEA definition of "swap" to exclude transactions between affiliated entities, resulting in additional statutory relief from certain

<sup>5</sup> H.R. 238, 115th Cong. § 321 (2017).

<sup>6</sup> H.R. 238, 115th Cong. § 311 (2017), *see also supra* note 5.

<sup>7</sup> H.R. 238, 115th Cong. § 311 (2017), *see also supra* note 5.

<sup>8</sup> H.R. 238, 115th Cong. § 307 (2017).

<sup>9</sup> Forward Contracts With Embedded Volumetric Optionality, 80 Fed. Reg. 28,239, 28,241 (May 18, 2015). For more information on the final interpretation, *see* Skadden's May 15, 2015, [client alert](#).

<sup>10</sup> H.R. 238, 115th Cong. § 304 (2017) (excluding from the definition of "financial entity" an entity that (1) does not meet any of the categories under the "financial entity" definition, (2) is not regulated by a Prudential Regulator, and (3) is either a commercial market participant (defined by the House Bill as "any producer, processor, merchant or commercial user of an exempt or agricultural commodity, or the products or byproducts of such a commodity") or an entity that enters into swaps, contracts for future delivery, or other derivatives on behalf of, or to hedge or mitigate the commercial risk of, affiliates).

<sup>11</sup> *See* Regulation Automated Trading, 81 Fed. Reg. 85,334 (proposed Nov. 25, 2016) (to be codified at 17 C.F.R. pts. 1, 38, 40 & 170); *see also id.* at 85,393 (Proposed CFTC Rule 1.84(b)). For more information on the Supplemental Notice of Proposed Rulemaking for Regulation AT and the proposals that would affect firms' intellectual property rights, *see* Skadden's November 2016 [client alert](#).

<sup>12</sup> *See* Regulation Automated Trading, 81 Fed. Reg. at 85,397 (dissent of Commissioner J. Christopher Giancarlo).

<sup>13</sup> H.R. 238, 115th Cong. § 318 (2017).

<sup>14</sup> *Id.* § 104.

<sup>15</sup> 17 C.F.R. § 1.22 (2016).

<sup>16</sup> *See* Residual Interest Deadline for Futures Commission Merchants, 80 Fed. Reg. 15,507 (Mar. 24, 2015). In 2015, the CFTC set the residual interest deadline at 6:00 p.m. *See* Residual Interest Deadline for Futures Commission Merchants, 80 Fed. Reg. 15,507 (Mar. 24, 2015). However, the rule also directed CFTC staff to publish a report on whether the CFTC should change the deadline, and the CFTC hosted a roundtable in March 2016 to hear comments on the report's findings. Press Release, *CFTC Staff to Host a Public Roundtable March 3 Regarding the Residual Interest Deadline*, CFTC, [http://www.cftc.gov/PressRoom/Events/opaevent\\_cftcstaff030316](http://www.cftc.gov/PressRoom/Events/opaevent_cftcstaff030316).

<sup>17</sup> H.R. 238, 115th Cong. § 415 (2017). *See also* 17 C.F.R. §§ 15.01, 15.02, 15.04 (2016).

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CFTC requirements on swap transactions entered into with affiliate counterparties.<sup>18</sup> Counterparties that are swap dealers (SDs) or major swap participants would still need to comply with reporting requirements and risk management requirements for affiliate transactions and with CFTC or federal banking regulators variation margin requirements for interaffiliate non-cleared swaps.<sup>19</sup>

**Swap Dealer De Minimis Threshold.** The House Bill proposes to amend the CEA definition of “swap dealer” to permanently set an \$8 billion de minimis threshold for determining whether an entity should be designated as a swap dealer.<sup>20</sup> The House Bill would also change the current CFTC threshold amendment process by requiring the CFTC to affirmatively lower the threshold by rule or regulation, rather than automatically lowering the threshold.<sup>21</sup>

**CFTC Procedures.** The House Bill would modify CFTC processes and procedures in ways that would, among other effects, limit the authority of the chairman and the staff, and make the rulemaking process more meticulous.<sup>22</sup> For example, heads of the operating divisions of the CFTC would serve at the pleasure of the Commission instead of at the pleasure of the chairman,<sup>23</sup> limiting the chairman’s ability to set the agency’s agenda. Before any CFTC division or office issues an exemptive, no-action or interpretative letter in response to a formal written request or petition from the public, the commissioners would need to receive the staff’s final version of the letter and be afforded adequate time to review it.<sup>24</sup> There also would be a notice and comment requirement for any CFTC statement or guidance that is voted on by the Commission, if that statement or guidance would implement, interpret or prescribe law or policy.<sup>25</sup> Moreover, the House Bill would require the Commission to assess and publish in a proposed rulemaking the proposed rule’s quantitative and qualitative costs and benefits.<sup>26</sup> The Commission also would be required to state in the proposed rulemaking the

statutory justification for the proposed rule.<sup>27</sup> The Commission would have to evaluate a number of different considerations in determining the rule’s costs and benefits.<sup>28</sup> In addition to this, the House Bill would allow a person adversely affected by a Commission rule to obtain judicial review in the U.S. Courts of Appeals.<sup>29</sup>

**Cross-Border Regulation of Derivatives Transactions.** If enacted, the House Bill would accelerate rulemaking, and certain comparability findings, for cross-border compliance, and authorize the CFTC to treat substituted compliance as a “two-way street” with respect to a foreign jurisdiction’s reciprocation of substituted compliance. Within a year of the House Bill’s enactment, the CFTC would be required to adopt criteria to assess whether a foreign jurisdiction’s swaps requirements are comparable to and as comprehensive as the CFTC’s requirements, identify circumstances under which a U.S. person or a transaction between a U.S. person and a non-U.S. person would be exempt from U.S. swaps requirements if the foreign jurisdiction’s swaps requirements are met, and identify which U.S. swaps regulations apply to the swap activities of non-U.S. persons and the non-U.S. branches of U.S. persons.<sup>30</sup> The regulations of the eight largest foreign swaps jurisdictions would be deemed by statute to be comparable to and as comprehensive as the U.S. swaps requirements 18 months after the House Bill’s enactment, unless the CFTC adopts the rules and makes comparability findings for those jurisdictions by that time.<sup>31</sup> The CFTC also would be able to suspend substituted compliance for a foreign jurisdiction that fails to provide equivalent recognition of, or substituted compliance for certain U.S.-domiciled entities, or fails to exempt U.S. persons complying with U.S. swaps requirements from the foreign jurisdiction’s swaps requirements.<sup>32</sup>

<sup>18</sup>H.R. 238, 115th Cong. § 320 (2017).

<sup>19</sup>For more information about the variation margin rules with respect to interaffiliate transactions, see Skadden’s Nov. 2, 2015, client alert [here](#).

<sup>20</sup>H.R. 238, 115th Cong. § 308 (2017). The current swap dealer de minimis threshold is \$8 billion, which will automatically descend to \$3 billion after Dec. 31, 2018. See Order Establishing De Minimis Threshold Phase-In Termination Date, 81 Fed. Reg. 71,605 (Oct. 18, 2016).

<sup>21</sup>17 C.F.R. § 1.3(ggg)(4) (2016).

<sup>22</sup>Many of these changes are among a number of “Commodity Futures Trading Commission Reforms” provisions of the most recent iteration of the proposed Financial CHOICE Act that were incorporated into the House Bill. Compare H.R. 238 §§ 203, 205-210, and 312 (2017), with Financial CHOICE Act, H.R. 5983, 114th Cong. §§ 461-468 (as reported by H. Fin. Serv. Comm., Dec. 20, 2016), available at <https://www.congress.gov/114/bills/hr5983/BILLS-114hr5983rh.pdf> (hereinafter “CHOICE Act”).

<sup>23</sup>H.R. 238, 115th Cong. § 203 (2017).

<sup>24</sup>*Id.* § 205.

<sup>25</sup>*Id.* § 209.

<sup>26</sup>See *id.* § 202.

<sup>27</sup>See *id.*

<sup>28</sup>See *id.* Both the proposed Financial CHOICE Act and the proposed Regulatory Accountability Act (H.R. 5) also would implement changes to the CFTC’s cost-benefit analysis processes and procedures. See, e.g., CHOICE Act § 612 (proposing to require new cost-benefit analysis processes and procedures for eight federal financial regulators, including the CFTC); H.R. 5, 115th Cong. § 103 (2017) (proposing to amend 5 U.S.C. § 553 and impose new rulemaking consideration requirements for federal agencies).

<sup>29</sup>See H.R. 238, 115th Cong. § 210 (2017). This provision also appears in the proposed Financial CHOICE Act. See also CHOICE Act § 467.

<sup>30</sup>H.R. 238, 115th Cong. § 312 (2017). These provisions are also incorporated from the most recent version of the proposed Financial CHOICE Act. See also CHOICE Act § 468.

<sup>31</sup>H.R. 238, 115th Cong. § 312 (2017).

<sup>32</sup>*Id.*