CFTC Issues Final Aggregation Rules for Position Limits

CFTC Unanimously Votes to Adopt Amendments and Updates to Its Aggregation Rules for Position Limits

SUMMARY

On December 5, 2016, the Commodity Futures Trading Commission (the “CFTC” or “Commission”) unanimously adopted final rules to amend and update Part 150 of the CFTC’s rules that govern the aggregation of certain positions under common ownership or control for purposes of the CFTC’s position limits regime for futures and option contracts on nine agricultural commodities (the “Final Rule”). The Final Rule will also govern aggregation for the purpose of any final position limits rules that the Commission may eventually adopt with respect to futures, options and economically equivalent swaps. This memorandum to clients represents our initial review and assessment of the release, which is 155 pages (in the pre-Federal Register version) and includes 349 footnotes. The Final Rule will become effective sixty days after it is published in the Federal Register; there is no extended transition period or compliance date.

The Final Rule largely follows the proposed amendments to the existing aggregation rules issued by the Commission on November 15, 2013 (the “Proposed Rule”), as updated by a supplemental notice issued on September 29, 2015 (the “Supplemental Notice”), subject to certain changes highlighted below. Consistent with the Proposed Rule and Supplemental Notice, the Final Rule broadens the scope of exemptions from the aggregation requirement as compared to the current aggregation rules and the Proposed Rule. Most importantly, the Final Rule establishes a new exemption – the “owned entity exemption” – which permits an owner entity to disaggregate its trading positions from the positions of any owned entity upon the filing of a notice with the Commission, so long as certain conditions continue to be met relating to the separation of trading information and control as between the entities.
OVERVIEW OF THE AGGREGATION FINAL RULE

A. PRESUMPTION OF AGGREGATION FOR COMMON OWNERSHIP, COMMON CONTROL, AND SUBSTANTIALLY IDENTICAL TRADING STRATEGIES

The Final Rule provides the standards to determine when positions in futures and options on futures held by separate, but related, entities are required to be aggregated for purposes of determining compliance with position limits and reporting under the CFTC’s large trader reporting rules. The rules will also apply with respect to positions in economically equivalent swaps once the CFTC finalizes the rules set forth in the Position Limits Re-Proposal. Under the Final Rule, consistent with its historical practice, the CFTC will treat multiple entities’ positions or accounts as being held by a single, consolidated entity for purposes of position limits and large trade reporting when those positions or entities are under common ownership, common control, or pursuing substantially identical trading strategies. Specifically, under the Final Rule:

- There is a general presumption that one entity’s control of or ownership of a ten percent or greater ownership or equity interest in another entity, position or account requires aggregation; and
- Any person that, by power of attorney or otherwise, holds or controls the trading of positions in more than one account or pool with substantially identical trading strategies must aggregate all such positions (determined on a pro rata basis) with all other positions held and trading done by such person and the positions in accounts which the person must otherwise aggregate.

With respect to comments that ownership should not be a basis for aggregation, the CFTC noted that it will continue to apply the ten percent ownership standard to determine whether aggregation is required (1) in order to establish a bright-line test for certainty and (2) to avoid having to individually assess control across all market participants (i.e., apply the test in prong (ii) above).

B. EIGHT EXEMPTIONS FROM AGGREGATION

As revised and updated by the Final Rule, Part 150 will provide eight specific exemptions from the aggregation requirement; however, no exemption is available for any person that, by power of attorney or otherwise, holds or controls the trading of positions in more than one account or pool with substantially identical trading strategies. The eight exemptions, each subject to various conditions which will be discussed in greater detail below, include exemptions for:

- Ownership interests in certain commodity pools and funds by limited partners, shareholders or other pool participants (the “LP Exemption”);
- Certain owner entities that own more than ten percent of an owned entity (the “Owned Entity Exemption”);
- Certain accounts held by a futures commission merchant (“FCM”) where another person is directing the trading in the FCM’s account (the “FCM Exemption”).

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On December, 5, 2016, the CFTC also re-proposed its rules for position limits, and our memorandum to clients reviewing that release is available here (the “Position Limits Re-Proposal”).

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Accounts of an eligible entity managed by an independent account controller (an “IAC”) (the “IAC Exemption”);

An ownership or equity interest in an entity that is based on the ownership of securities constituting the whole or a part of an unsold allotment to or subscription by such person as a participant in the distribution of securities by the issuer or by or through an underwriter (the “Underwriting Exemption”);

An ownership or equity interest that is based on the ownership of securities by a broker-dealer or similarly registered entity acquired in the normal course of business as a dealer (the “Broker-Dealer Exemption”);

Scenarios in which the sharing of information associated with aggregation creates a reasonable risk that either person could violate state or federal law or the law of a foreign jurisdiction, or regulations adopted thereunder (the “Information Sharing Exemption”); and

Affiliated entities in a corporate structure such that one entity may file a single notice for aggregation relief on behalf of any or all of its affiliates provided that the conditions applicable to the exemption specified in such notice filing are satisfied by each affiliate and none of the affiliates otherwise control trading of any account or position identified in the notice filing (the “Affiliated Entity Exemption”).

C. NOTICE FILING REQUIREMENT

Consistent with the Proposed Rule and Supplemental Notice, the Final Rule requires that a person seeking an exemption under the following exemptive categories must make a notice filing with the Commission (which will be effective upon filing): the Owned Entity Exemption, the FCM Exemption, the IAC Exemption, the Information Sharing Exemption, and the LP Exemption (when the limited partner(s) claiming the exemption are principals or affiliates of the operator of the pooled account).

There is no notice filing requirement for the LP Exemption (when the limited partner(s) claiming the exemption are not principals or affiliates of the operator of the pooled account), the Underwriting Exemption, or the Affiliated Entity Exemption. Any required notice filing must, among other requirements, contain a description of the relevant circumstances that warrant disaggregation and a certification from a senior officer of the entity making the notice filing that the conditions of the relevant exemption have been met.

D. COMPLIANCE DATE

As noted above, the CFTC’s Final Rule release provides that the Final Rule will be effective sixty days after publication in the Federal Register. The Commission noted that it had considered comments requesting an additional compliance or transition period during which the rule would not be enforced. However, the Commission determined that additional time would not be “necessary or appropriate” for the Final Rule, noting also that a period of sixty days would be appropriate to prepare for effectiveness of the Final Rule. As of the date of this memorandum, the release has not yet been published in the Federal Register.
FURTHER DESCRIPTION OF THE LP, OWNED ENTITY, AND IAC EXEMPTIONS

A. LP EXEMPTION

The LP Exemption in the Final Rule is an amended version of the analogous exemption in the CFTC’s current aggregation rules. Under the LP Exemption in the Final Rule, a limited partner, limited member, shareholder or other similar type of pool participant (each generally referred to herein as a limited partner) holding a ten percent or greater ownership or equity interest in a pooled account or positions is not required to aggregate the accounts or positions of the pool with any other accounts or positions of such person. The LP Exemption is not available for an entity that is also the commodity pool operator (“CPO”) of the pooled account. In addition, where the limited partner is a principal or affiliate of the CPO of the pooled account, (i) the CPO must have and enforce written procedures to preclude the limited partner from having knowledge of, gaining access to, or receiving data about the trading or positions of the pool; (ii) the limited partner cannot have direct, day-to-day supervisory authority or control over the pool’s trading decisions; (iii) the limited partner, if a principal of the CPO, may maintain only such minimum control over the CPO as is consistent with its responsibilities as a principal and necessary to fulfill its duty to supervise the trading activities of the commodity pool; and (iv) the CPO must comply with the notice filing requirements (discussed below) on behalf of the limited partner.

The Commission retained the provision in the LP Exemption, as it exists in the current Part 150 rules of the CFTC, that makes the exemption unavailable for a limited partner that has a twenty-five percent or greater ownership or equity interest in a commodity pool for which the CPO is exempt from CPO registration pursuant to CFTC rule 4.13.

B. OWNED ENTITY EXEMPTION

The Final Rule includes a new Owned Entity Exemption, which does not exist under the current aggregation rules. The Owned Entity Exemption permits any person with an ownership or equity interest in an owned entity of ten percent or greater (other than an interest in a pooled account, which is not eligible for the Owned Entity Exemption but that may be eligible for the LP Exemption) to disaggregate the accounts or positions of the owned entity from any other accounts or positions such person is required to aggregate, which is claimed by submitting a notice filing to the CFTC. Both the owner and owned entities are subject to certain conditions, and the CFTC indicated that these conditions should be applied consistent with the CFTC’s historical practice with respect to aggregation exemptions containing analogous conditions and that the CFTC “would not expect that [these] criteria would impose requirements beyond a reasonable, plain-language interpretation of the criteria.” The conditions are as follows:

In order to rely on the Owned Entity Exemption, each of the owner entity, including any entity with which such person must aggregate, and the owned entity (to the extent that such person is aware or should be aware of the activities and practices of the aggregated entity or the owned entity) must:
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- Not have knowledge of the trading decisions of the other;
- Trade pursuant to separately developed and independent trading systems;
- Have and enforce written procedures to preclude it from having knowledge of, gaining access to, or receiving data about, trades of the other, including document routing and other procedures or security arrangements, including separate physical locations, which would maintain the independence of their activities;
- Not share employees that control the trading decisions of the other; and
- Not have risk management systems that permit the sharing of trades or trading strategy.

In finalizing the Owned Entity Exemption, the CFTC clarified certain of the conditions:

- The phrase “to the extent that such person is aware or should be aware of the activities and practices of the aggregated entity or the owned entity” was included in recognition of the fact that, as commenters pointed out, an owner may not have knowledge of or an ability to find out about the trading practices of an owned entity; in this case, the CFTC clarified that if the owner entity is not aware, and should not be aware, of the owned entity’s activities, the owner entity would not have to certify as to the owned entity – instead, passive investors in an owned entity would be required to certify only that they have no knowledge of the owned entity’s trading;
- “Knowledge of the trading decisions of the other” would not include the sharing of information for risk management purposes provided that the information is not used for trading;
- “Trading systems” is meant to encompass systems or programs that provide the impetus for the initiation of trades, specifically noting that the use of a shared order execution platform (defined as a computerized process that accepts inputs of terms of trades desired to be made and then uses pre-determined methods to specifically place those trades in the market) is not viewed as a “trading system”, (defined generally as a process or method for deciding on timing and direction of trades), as long as appropriate firewalls are in place;
- “Separate physical locations” would not necessarily require that the relevant personnel be located in separate buildings provided that there be a physical barrier between the personnel that prevents access (e.g., locked doors with restricted access);
- The prohibition against sharing employees would not apply to the sharing of attorneys, accountants, risk managers, compliance and other mid- and back-office personnel between entities provided that the employees do not control, direct or participate in the entities’ trading decisions; and
- Generally speaking, information may be shared to be used only for risk management and surveillance purposes, when such information is not used for trading purposes and not shared with employees that control, direct or participate in the entities’ trading decisions, and such information may be shared on a real-time basis, and may be used to effect reductions in non-hedging positions where such reductions are mandated by pre-established credit risk management procedures or compliance procedures regarding permissible investment activities.

C. IAC EXEMPTION

The IAC Exemption in the Final Rule constitutes an amended version of the analogous exemption in the CFTC’s current aggregation rules. Under the IAC Exemption in the Final Rule, an “eligible entity” need not aggregate its positions with the eligible entity’s client positions or accounts carried by an authorized IAC, subject to a notice filing requirement (discussed below), and certain other conditions. The IAC Exemption is not available during the spot month in physical-delivery commodity contracts, and any IAC
remains separately responsible for complying with its own position limits for the overall positions that it holds or controls.

**Eligible Entity**

An eligible entity is defined in the Final Rule as:

- an entity that is a CPO;
- the operator of a trading vehicle which is excluded, or which itself has qualified for exclusion from the definition of the term “pool” or “CPO,” respectively, under CFTC rule 4.5;
- the limited partner, limited member or shareholder in a commodity pool the operator of which is exempt from registration under CFTC rule 4.13;
- a commodity trading advisor;
- a bank or trust company;
- a savings association;
- an insurance company; or
- the separately organized affiliates of any of the above entities.

In each instance, the eligible entity must have authorized an IAC independently to control all trading decisions with respect to the eligible entity’s client positions and accounts that the IAC holds directly or indirectly, or on the eligible entity’s behalf, but without the eligible entity’s day-to-day direction; and the eligible entity may maintain:

- only such minimum control over the IAC as is consistent with its fiduciary responsibilities to the managed positions and accounts, and necessary to fulfill its duty to supervise diligently the trading done on its behalf; or
- if a limited partner, limited member or shareholder of a commodity pool the operator of which is exempt from registration under CFTC rule 4.13, only such limited control as is consistent with its status.

**Independent Account Controller**

An IAC is defined in the Final Rule as a person:

- who specifically is authorized by an eligible entity independently to control trading decisions on behalf of, but without the day-to-day direction of, the eligible entity;
- over whose trading the eligible entity maintains only such minimum control as is consistent with its fiduciary responsibilities for managed positions and accounts to fulfill its duty to supervise diligently the trading done on its behalf or as is consistent with such other legal rights or obligations which may be incumbent upon the eligible entity to fulfill;
- who trades independently of the eligible entity and of any other IAC trading for the eligible entity;
- who has no knowledge of trading decisions by any other IAC; and
- who is (i) registered as a FCM, an introducing broker, a commodity trading advisor, or an associated person of any such registrant, or (ii) a general partner, managing member or manager...
of a commodity pool the operator of which is excluded from registration under CFTC rules 4.5(a)(4) or 4.13, provided that such general partner, managing member or manager complies with a notice filing requirement (discussed below).

Additional Requirements for Affiliated Entities under the IAC Exemption

There are additional requirements if the IAC is an affiliate of the eligible entity or another IAC. In that case, each of the affiliated entities must:

- have, and enforce, written procedures to preclude the other affiliated entity from having knowledge of, gaining access to, or receiving data about, trades of the other, and such procedures must include security arrangements, including separate physical locations, which would maintain the independence of their activities; however, such procedures may provide for the disclosure of information which is reasonably necessary for an eligible entity to maintain the level of control consistent with its fiduciary responsibilities to the managed positions and accounts and necessary to fulfill its duty to supervise diligently the trading done on its behalf;
- trade such accounts pursuant to separately developed and independent trading systems;
- market such trading systems separately; and
- solicit funds for such trading by separate disclosure documents that meet the standards of CFTC rules 4.24 or 4.34, as applicable, where such disclosure documents are required under Part 4 of the CFTC’s rules.

NOTICE FILING REQUIREMENT

Final Rule 150.4(c) describes the newly created notice filing regime pertaining to claiming certain exemptions from the aggregation requirement. Persons seeking an exemption from aggregation under the Owned Entity Exemption, the FCM Exemption, the IAC Exemption, the Information Sharing Exemption, and the LP Exemption (for principals or affiliates of the operator of the pooled account) must file a notice with the Commission that includes a description of the relevant circumstances that warrant disaggregation and a certification by a senior officer (or comparable position) that the conditions for the applicable aggregation exemption provision have been met. In addition, upon call, any person claiming an aggregation exemption will be required by the Commission to provide any requested information demonstrating that the person meets the requirements. The CFTC noted that the notice filing should be updated or amended only if there is a material change to the information provided in any notice.

In finalizing the notice filing requirement, the CFTC offered several clarifications with respect to interpreting and complying with its requirements:

- For the purposes of the Owned Entity Exemption, the CFTC confirmed that if a person obtains a newly acquired ownership or equity interest in an owned entity of ten percent or greater and is eligible for the Owned Entity Exemption, that person may elect that the notice claiming the exemption be effective as of the date of the acquisition if such notice is filed no later than sixty days after such acquisition.
- The failure to timely file a notice filing (if otherwise eligible to claim the exemption) would not be a violation of the aggregation requirement or of a position limit so long as the required filing is made within five business days after a person is aware, or should have been aware, that the notice has
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not been timely filed. However, the Commission noted that similar relief is not available if a person is not eligible to claim an exemption from aggregation but erroneously believes that it is (even if the error occurs in good faith). In that case, the Commission clarified that the person could not "cure" the situation by taking steps to become eligible for the exemption and claim that a notice filing has retroactive effect.

- The Final Rule would allow a notice filing that covers multiple entities so long as the explanation within the notice filing is sufficiently detailed as to each entity seeking to be covered by the exemption.

OTHER NOTABLE ISSUES

A. GUIDANCE ON THE INFORMATION SHARING EXEMPTION

The Information Sharing Exemption provides an exemption from the aggregation requirements under certain conditions where the sharing of information would cause a violation of state or federal law or the law of a foreign jurisdiction, or regulations adopted thereunder. This exemption is intended to respond to the concern that a market participant could face increased liability under antitrust or other laws that prevent information sharing. The exemption requires the market participant seeking such exemption to provide in its notice filing a written "memorandum of law" explaining the legal basis for determining that information sharing creates a "reasonable risk" that either person could violate federal, state, or federal law. In describing its expectations with respect to the "memorandum of law" requirement, the CFTC distinguished such memorandum of law from a short summary or copy of the legal authority creating the concern (which would be insufficient) and a formal opinion of counsel (which would generally go beyond what is necessary). The CFTC clarified that the memorandum of law must cite to the legal authority creating the concern and be accompanied by an explanation of the legal basis for determining that information sharing creates a reasonable risk that either person could violate federal, state, or foreign law, which contains information sufficient to allow Commission staff to review the legal basis asserted. In response to commenters, the CFTC clarified that supranational laws (such as the laws of the European Union) constitute laws of a foreign jurisdiction for purposes of the Information Sharing Exemption. Similarly, the release notes that the Commission's own regulations may be a basis for the exemption if they meet the same standard of being the basis for a reasonable risk of violation arising from information sharing. The Commission also clarified that the memorandum of law may be prepared by an employee of the firm or an employee of an affiliate of the firm that is seeking exemption and that a memorandum of law is not necessarily a formal opinion of counsel.

B. GUIDANCE ON UNDERWRITING AND BROKER-DEALER EXEMPTIONS

Underwriting Exemption

The Underwriting Exemption provides an exemption from aggregation where an ownership interest is in an unsold allotment of securities. For purposes of this exemption, the CFTC will interpret "unsold allotment" along the lines that it is interpreted under the Securities Exchange Act of 1934.
Broker-Dealer Exemption

In response to a commenter’s question regarding the Broker-Dealer Exemption, the Commission clarified that it expects traditional standards of a broker-dealer’s due diligence to apply.
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