House Passes CFTC Reauthorization Bill


INTRODUCTION

On June 24, 2014, the House of Representatives voted 265 to 144 to pass H.R. 4413, entitled the “Customer Protection and End-User Relief Act” (the “Reauthorization Act”). The Reauthorization Act reauthorizes the operations of the Commodity Futures Trading Commission (the “CFTC”) through the 2018 fiscal year. In addition to reauthorizing the CFTC, the Reauthorization Act would, if enacted, amend the Commodity Exchange Act (the “CEA”), among other things, to:

- require statutorily the CFTC and Securities and Exchange Commission (“SEC”) to issue joint rules regarding the application of U.S. swaps rules to transactions made between U.S. and foreign entities;
- modify the requirements for the CFTC’s cost-benefit analyses for rules promulgated under the CEA;
- enhance certain protections afforded to customers of futures commission merchants (“FCMs”);
- require the CFTC to conduct a study on high-frequency trading no later than one year after the enactment of the bill;
- amend the procedures for taking actions without a full vote of the CFTC commissioners; and
- provide relief to end-users from certain requirements implemented under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

The Reauthorization Act will now be considered by the Senate and will need to be passed by the Senate and signed by the President prior to enactment. The Senate is not expected to pass the Reauthorization Act in the form passed by the House and will likely offer a Senate version with substantial differences from the House’s Reauthorization Act. The bills must then be reconciled by Congress before they are presented to the President. Furthermore, the Reauthorization Act, as passed by the House, does not
provide the CFTC with additional funding and imposes new requirements on its operation, to which the CFTC will likely object. If the House and the Senate fail to reach an agreement on an act to reauthorize the CFTC, Congress will likely be forced to reauthorize the CFTC temporarily for an additional year based on its current statutory authorization.

**Enhanced Protection for Customers of FCMs**

The Reauthorization Act would provide clarification of certain protections afforded to customers of FCMs that are clearing derivative contracts through derivatives clearing organizations. Pursuant to Section 4d of the CEA, an FCM is required to hold sufficient funds in each of its customer accounts (by product type (e.g., futures, swaps, etc.) to satisfy its customers’ margin requirements for the customers’ cleared positions.\(^1\) In a recent final rule, the CFTC explained that it interprets the CEA to prohibit an FCM from using margin furnished by one customer to satisfy the margin requirements of another customer of the FCM in any manner.\(^2\) In light of this interpretation, the CFTC adopted rules that require that, at the end of each day, an FCM must maintain a residual interest (i.e., its own assets that it deposits in the account as customer funds) in each of its customer segregated accounts in an amount sufficient to cover any shortfall in a specific customer’s initial margin with respect to that customer’s margin requirement for that day.\(^3\) Certain changes to the CEA in the Reauthorization Act effectively would require that, if the CFTC adopts rules that require an FCM to hold a residual interest in its customer segregated account in an amount sufficient to exceed a specific customer’s margin deficits, the rule can only require the residual interest requirement to be calculated at the end of the business day as of the close of business on the previous day. The Reauthorization Act would also include a provision that overrules a prior bankruptcy court decision\(^4\) and would require statutorily that “customer property” in an FCM bankruptcy would include most unencumbered cash, securities, or other property of a commodity broker’s estate but only to the extent that the property that is otherwise deemed to be “customer property” is insufficient to satisfy the net equity claims of the FCM’s public customer account. This amendment would effectively give customers of a bankrupt FCM a higher priority in the general assets of the FCM’s estate if the assets in the customer account are not sufficient to satisfy customer claims.

**High-Frequency Trading**

In response to the recent allegations with respect to, and focus on, high-frequency trading, the Reauthorization Act would also require that the CFTC perform a study of high-frequency trading in markets subject to the CFTC’s jurisdiction.

**Cost Benefit Analysis**

Currently, the CFTC is required to consider the costs and benefits of any regulation prior to promulgating such regulation. In particular, the CFTC is required to consider:

- the protection of market participants and the public;
- the efficiency, competitiveness and financial integrity of the futures market;
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- price discovery; and
- sound risk management practices.

The Reauthorization Act would require that the CFTC, in engaging in this cost-benefit analysis, also consider:

- the impact on market liquidity in the futures and swaps markets;
- available alternatives to direct regulation;
- the degree and nature of the risks posed by various activities within the scope of its jurisdiction;
- the costs of complying with the proposed regulation or order by all regulated entities, including a methodology for quantifying the costs (recognizing that some costs are difficult to quantify); and
- whether the proposed regulation or order is inconsistent, incompatible, or duplicative of other Federal regulations or orders.

The imposition of these additional factors that the CFTC must consider with respect to each rulemaking could make it more difficult for the CFTC to adopt regulations in certain instances and would likely facilitate legal challenges to CFTC rulemaking.

Commission Action with No Vote
In the wake of the Dodd-Frank Act-related rulemakings, the CFTC staff issued a substantial number of letters providing interpretations of various rules, as well as no-action relief (including delaying the compliance date of certain rules). In response to those issuances, the Reauthorization Act would institute a procedure governing these staff actions that are issued without a vote of the Commissioners, pursuant to which the staff would be required to notify the Commissioners prior to issuing any response to a formal, written request or petition from any member of the public for an exemptive, no-action, or interpretive letter.

Judicial Review of Commission Rules
The Reauthorization Act would provide a means for market participants to challenge rules promulgated by the CFTC under the CEA. In particular, the Reauthorization Act would provide that a person adversely affected by a rule adopted by the CFTC may request that a U.S. Court of Appeals review the rule and consider a written petition requesting that the new rule be set aside.

End User Relief
In enacting the Dodd-Frank Act, Congress generally indicated that it did not intend to impose significant regulatory requirements on commercial end users of derivative products or to limit their ability to engage in, or increase their cost of, hedging transactions.5 The Reauthorization Act provides relief to these end users with respect to certain regulations implemented by the CFTC under the Dodd-Frank Act with regard to, among other things:

- margin requirements for uncleared swaps;
- swaps with non-financial entity affiliates;
certain swaps with special entities that are utilities;
• the definition of “financial entity”;
• reporting of certain illiquid swaps;
• end user recordkeeping requirements;
• forward contracts with volumetric optionality; and
• the definition of \textit{bona fide} hedging.

With respect to uncleared margin requirements, the Reauthorization Act would statutorily provide that the uncleared margin requirements do not apply to swaps with respect to which one counterparty would qualify for the non-financial end-user exception to clearing under Section 2(h)(7)(A) or would otherwise be exempt from the clearing requirement, regardless of whether the swap is subject to the clearing requirement. This relief would apply to both CFTC-regulated swaps as well as SEC-regulated security-based swaps. As proposed, the CFTC’s uncleared margin rules would not impose margin requirements on non-financial end users while the banking regulators’ uncleared margin rules may impose margin requirements on non-financial end users (albeit with very high threshold levels). The Reauthorization Act would statutorily prohibit imposing margin requirements on certain swaps of non-financial end users.

The Reauthorization Act would provide relief with respect to the definition of “financial entity”. Under the CEA, a financial entity is defined currently as:

• a swap dealer;
• a security-based swap dealer;
• a major swap participant;
• a major security-based swap participant;
• a commodity pool;
• a “private fund”;
• an “employee benefit plan”; or
• a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature.

The Reauthorization Act would provide that an entity, which might otherwise be captured within the definition of financial entity by the last prong, with an affiliate that qualifies for the non-financial end-user exception to the clearing requirement under Section 2(h)(7)(A), could rely on that exception, provided that the entity is entering into the swap to hedge or mitigate the commercial risk of the non-financial affiliate, subject to certain credit support conditions.

The Reauthorization Act would also provide relief from the definition of “financial entity” for commercial market participants (who may be financial entities because they are predominantly engaged in physical delivery contracts) and persons who use derivatives to mitigate commercial risk. The Reauthorization
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where the exercise of any embedded option in such contract would result in a physical delivery obligation;

where any embedded optionality cannot be severed or marketed separately from the overall transaction for the purpose of financial settlement; and

with respect to which both parties are commercial market participants,

would be a forward contract that is excluded from the definition of swap. This exclusion would apply to both embedded options and stand-alone options.\textsuperscript{17}

The Reauthorization Act would provide additional clarity to the definition of \textit{bona fide} hedging and provide the CFTC with the authority to define further which activities may constitute \textit{bona fide} hedging.

\textbf{Cross Border Rules}

Although both the CFTC and the SEC have adopted guidance or rules concerning the cross-border applicability of certain of each agency’s swaps-related rules,\textsuperscript{18} the Reauthorization Act would require the CFTC and SEC jointly to adopt rules that govern the application of the requirements applicable to U.S. swaps to transactions involving U.S. persons or non-U.S. persons. The joint rules must address:

- the nature of the connections to the United States that require a non-U.S. person to register as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant under each Commission’s respective Acts and the regulations issued under such Acts;

- which of the United States swaps requirements shall apply to the swap and security-based swap activities of non-U.S. persons, U.S. persons, and their branches, agencies, subsidiaries, and affiliates outside of the United States and the extent to which such requirements shall apply; and

- the circumstances under which a non-U.S. person in compliance with the regulatory requirements of a foreign jurisdiction shall be exempt from United States swaps requirements.

The Reauthorization Act would prohibit either agency from issuing any guidance, memorandum of understanding, or any similar type of agreement in lieu of a joint rulemaking. The Reauthorization Act would also define the term “U.S. person” to mean:

- any natural person resident in the U.S.;

- any partnership, corporation, trust, or other legal person organized or incorporated under the laws of the United States or having its principal place of business in the U.S.;

- any account (whether discretionary or non-discretionary) of a U.S. person; and

- any other person as the CFTC and SEC may further jointly define to more effectively carry out the purposes of this Act.

This definition would specifically exclude the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, their agencies and pension plans, and any other similar international organizations and their agencies and pension plans from the definition of U.S. Person.
Reaction to Reauthorization Act

On June 19, 2014, the Executive Office of the President issued a statement regarding the Reauthorization Act. The administration stated that it “strongly opposes the passage of H.R. 4413 [(i.e., the Reauthorization Act)] because it undermines the efficient functioning of the [CFTC] by imposing a number of organizational and procedural changes and offers no solution to address the persistent inadequacy of the agency’s funding.” In light of the fact that “[t]he enactment of the Dodd-Frank Act resulted in significant expansion of the CFTC’s responsibilities,” the Administration expressed concerns that the Reauthorization Act would “hinder the CFTC’s progress in successfully implementing these critical responsibilities and would unnecessarily disrupt the effective management and operation of the agency, without providing the more robust and reliable funding that the agency needs.”

On June 24, 2014, Sen. Debbie Stabenow, Chairwoman of the U.S. Senate Committee on Agriculture, Nutrition and Forestry, released a statement on the passage of the Reauthorization Act stating that she was “pleased to see the House bill includes measures related to customer protections as well as important considerations for end users.” However, she expressed disappointment that “the bill provides no additional funding mechanism and adds new layers of administrative burdens, hindering the agency’s ability to do its job and effectively regulate these markets.”
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17 Effectively, this would exclude from the definition certain contracts that qualify for treatment as “trade options” under the CFTC’s current commodity option rules. See 17 C.F.R. Part 30.


20 Id.

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