Morgan Lewis

ADVANCED TOPICS IN HEDGE FUND PRACTICES CONFERENCE

Manager and Investor Perspectives

WEBINAR SERIES

SESSION 7 | Tuesday, June 2

Trading and Investment Practices Affecting Hedge Funds
Family Office Issues and Considerations
LIBOR Transition and Derivatives Update

TRADING AND INVESTMENT PRACTICES AFFECTING HEDGE FUNDS

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Overview – Rules 5130 and 5131 and Amendments

- Rules 5130 and 5131 (the Rules) promote fairness in the allocation of new issues of equity securities and were **amended effective January 1, 2020.**
- The amendments to Rules 5130 and 5131 clarify and liberalize the Rules by broadening the Rules' exclusions and exemptions.
- Rule 5130 prevents broker-dealers and portfolio managers from receiving shares of equity securities in IPOs (new issues).
- Rule 5131 prevents broker-dealers from allocating new issues to individuals who have the authority or ability to direct their company's investment banking business to the broker-dealer making the allocation.
- Technically, the Rules apply only to broker-dealers, but they impact the operations of other types of firms, including fund managers, that must make representations to broker-dealers as to the nature of their investors in order to receive new issue allocations.

Rule 5130

- Prohibits allocations of new issues to accounts of Restricted Persons:
  - broker-dealers,
  - persons who own or control broker-dealers,
  - portfolio managers, and
  - others.
- Exemptions and exclusions recognize that some entities and offerings do not implicate new issue allocation concerns.
- Applies to all "new issues" of securities, basically IPOs, with limited exceptions.
- Contains a *de minimis* threshold for Restricted Persons.
- Permits annual attestation by negative consent.

Rule 5131

- Prohibits quid pro quo allocations of "new issues," as defined in Rule 5130, in exchange for excessive compensation.
- Prohibits allocation of new issue securities to "Covered Persons," who are those in a position to direct hiring of broker-dealers for investment-banking services.
  - Covered Persons include executive officers or directors of public companies and covered nonpublic companies – e.g., the prospective investment banking clients.
- Limits flipping of new issue securities and prescribes certain pricing and trading practices for new issues.
- Incorporates the general exemptions of Rule 5130 (with a different *de minimis* threshold).
  - Therefore, amendments to the general exemptions apply to both Rule 5130 and 5131.

Amendments to Rules 5130 & 5131

NEW GENERAL EXEMPTION FOR RETIREMENT BENEFITS PLANS

- Retirement plans – The Rules now include a general exemption for accounts of retirement plans or a family of plans, whether organized under US or non-US law, that:
  - have, in aggregate, at least 10,000 plan participants and beneficiaries and $10 billion in assets;
  - are operated in a nondiscriminatory manner insofar as a wide range of employees, regardless of income or position, are eligible to participate without further amendment or action by the plan sponsor;
  - are administered by trustees or managers that have a fiduciary obligation to administer the funds in the best interests of the participants and beneficiaries; and
  - are not sponsored solely by a broker-dealer.
- Plans that do not qualify under the new general exemption may still seek exemptive relief on a case-by-case basis.

Amendments to Rules 5130 & 5131

AMENDED GENERAL EXEMPTION FOR FOREIGN INVESTMENT COMPANIES

- Foreign investment companies – The amendments expand the general exemption for accounts of investment companies organized under the laws of a foreign jurisdiction.
  - Previously, a foreign investment company's account was exempt from Rule 5130 only if (1) it was listed on a foreign exchange or authorized for sale to the public in a foreign country, and (2) no Restricted Person owns no more than 5% of the foreign investment company.
  - The amendments provide two alternatives to the 5% Restricted Person ownership limitation. The exemption would be available to a foreign investment company with at least:
    - 100 direct investors, or
    - 1,000 indirect investors.
  - The amendments also require that the foreign investment company is not formed for the specific purpose of permitting Restricted Persons to invest in new issues.

Amendments to Rule 5130

NEW EXCLUSION FOR SOVEREIGN ENTITIES

- Sovereign entities that own broker-dealers were previously Restricted Persons if they had a voting or other equity ownership stake in a broker-dealer that required disclosure on SEC Form BD (generally 10% or more of direct ownership or 25% or more of indirect ownership).
- The amendments exclude sovereign entities from the definition of "Restricted Person."
- The amendments have the effect of permitting accounts of sovereign entities to receive new issue allocations even if the sovereign entity has an ownership stake in a broker-dealer over the thresholds for disclosure.
- The amendments define "sovereign entity" as:
  - a sovereign nation, or
  - a pool of capital or an investment fund or other vehicle owned or controlled by a sovereign nation and created for the purpose of making investments on behalf or for the benefit of the sovereign nation.

Amendments to Rule 5130

EXPANDED DEFINITION OF "FAMILY INVESTMENT VEHICLE"

- Portfolio managers of collective investment accounts are Restricted Persons, with limited exceptions.
- Portfolio managers to family investment vehicles (family offices) are not Restricted Persons.
  - Prior to the amendments to Rule 5130, the definition of "family investment vehicle" in Rule 5130 was narrower than the definition in the Investment Advisers Act (the Advisers Act).
  - This resulted in some family offices being Restricted Persons.
- Rule 5130 has been amended to expand the definition of "family investment vehicle" so that it is consistent with the concept of family office found in the Advisers Act.
  - Specifically, "family investment vehicles" for purposes of Rule 5130 now include those that invest on behalf of multiple generations and also those that include as beneficiaries key employees, including advisers from the family office, even though not family members.

Amendments to Rule 5131

UNAFFILIATED CHARITABLE ORGANIZATIONS

- The definition of "covered non-public company" was amended to exclude "unaffiliated charitable organizations."
- This change removes from Covered Persons executive officers and directors of unaffiliated charitable organizations.

Amendments to the Definition of "New Issue"

EXCLUSIONS FOR FOREIGN OFFERINGS OF SECURITIES, SPAC

- **Foreign Offerings**
  - The amendments add an exclusion from the definition of "new issues" for securities offered pursuant to Regulation S of the Securities Act (Reg S) or otherwise offered outside the United States.
  - **Note:** The exclusion does not apply to Reg S offerings of securities that also are registered and concurrently offered as new issues in the United States unless offered outside the United States by a non-US broker/bank that is a member of the selling syndicate in its own right.
- **SPACs**
  - The amendments add special purpose acquisition companies (SPACs) to the list of products excluded from the definition of "new issue." The Rules already excluded business development companies, direct-participation programs, and real estate investment trusts, among other securities.

Additional Amendments

- **Antidilution Provisions (Rule 5131)** – FINRA added supplemental materials to Rule 5131 to add antidilution provisions (similar to those already in Rule 5130) to permit the allocation of new issues to Covered Persons in order for them to maintain the percentage of equity ownership they held before the IPO.
  - Both Rule 5130 and Rule 5131 include conditions for reliance on the antidilution provisions.
- **Issuer-Directed Securities** – The definition of "issuer-directed securities" was harmonized in the Rules by amending Rule 5130 to make this provision consistent with Rule 5131 to exempt from the Rules prohibitions allocations directed by affiliated and selling shareholders.

Key Takeaways on the Rule 5130 and 5131 Amendments

- The amendments expand the universe of eligible recipients of allocations of new issue securities.
- Offerings made pursuant to Reg S (and not concurrently offered in the United States) are expressly excluded from "new issue."
- Private fund managers and sponsors will need to update their investor information in order to maximize the availability of exclusions and exemptions under the amendments.
  - Update subscription documents
  - Consider outreach to current investors that are Restricted Persons or Covered Persons to determine if the investors are now eligible to receive new issue allocations.

Proposed Amendments to Definitions of Accredited Investor and Qualified Institutional Buyer

- The goal is to improve the definition in order to identify more effectively institutional and individual investors that have the knowledge and expertise to participate in our private capital markets and therefore do not need the additional protections of registration under the Securities Act. The proposals would add:
  - new categories of natural persons that may qualify as accredited investors based on certain professional certifications
  - status as a private fund's "knowledgeable employee"
  - expand the list of entities that may qualify as accredited investors and allow entities meeting an investments test to qualify
  - family offices with at least $5 million in assets under management and their family clients
  - expand the list of entities that are eligible to qualify as qualified institutional buyers

Professional Certifications and Designations and Other Credentials

- The proposed amendment would provide the following nonexclusive list of attributes that the Commission would consider in determining which professional certifications and designations or other credentials of individuals qualify for accredited investor status:
  - the certification, designation, or credential arises out of an examination or series of examinations administered by a self-regulatory organization or other industry body, or is issued by an accredited educational institution;
  - the examination or series of examinations is designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing;
  - persons obtaining such certification, designation, or credential can reasonably be expected to have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment; and
  - an indication that an individual holds the certification or designation is made publicly available by the relevant self-regulatory organization or other industry body.

Professional Certifications and Designations and Other Credentials

- Preliminary list of qualifications to be included in initial Commission order:
  - Licensed General Securities Representative (Series 7)
  - Licensed Investment Adviser Representative (Series 65)
  - Licensed Private Securities Offerings Representative (Series 82)

- Other possibilities based on prior comments:
  - certified public accountant (CPA)
  - certified financial analyst (CFA)
  - certified management accountant (CMA)
  - investment adviser representative or registered representative (RR)
  - having a Masters of Business Administration degree (MBA) from an accredited educational institution
  - having a certified investment management analyst (CIMA) certification
  - having been in the securities industry as a broker, lawyer, or accountant

Knowledgeable Employees of Private Funds

- Knowledgeable employees of private funds within the meaning of Rule 3c-5 would be eligible to invest in their funds under Rule 506 as accredited investors, rather than relying on Section 4(a)(2).
  - Currently not counted within 100 beneficial owners under Rule 3(c)(1) and treated as qualified purchasers under Rule 3(c)(7).
  - Small funds with less than $5 million in assets will still qualify as accredited investors if a knowledgeable employee participates, if all equity owners are accredited. Rule 501(a)(8).

New Categories of Entities

- Rule 501(a) provides an exclusive list of entities that may qualify as accredited investors. The Commission proposed to include the following additional categories:
  - Registered Investment Advisers
  - Rural Business Investment Companies (RBICs)
  - Limited Liability Companies (LLCs) (codifying staff no-action position)
  - Other Entities Meeting an Investments-Owned Test
    - Indian tribes, labor unions, governmental bodies and funds, and entities organized under the laws of a foreign country are not specifically listed in the accredited investor definition
    - $5 million-total-investments test vs. $5 million-total-assets thresholds

Family Offices and Family Clients

- Advisers Act Rule 202(a)(11): A family office generally is a company that has no clients other than "family clients." "Family clients" generally are family members, former family members, and certain key employees of the family office, as well as certain of their charitable organizations, trusts, and other types of entities.
  - at least $5 million in assets under management
  - not formed for the specific purpose of acquiring the securities offered

Qualified Institutional Buyer Definition

- With the exception of registered dealers, a qualified institutional buyer (QIB) must in the aggregate own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with that qualified institutional buyer.
  - Banks and other specified financial institutions are subject to an additional minimum audited net worth requirement of $25 million
- Like Rule 502(a), Rule 144A(a)(1) provides a list of specific types of institutional investors that qualify as QIBs. Issues have arisen with respect to certain types of institutional investors, particularly with respect to:
  - state and municipal governments,
  - sovereign wealth funds,
  - bank-sponsored common trust funds that include HR10 plans as participants
- Commission proposed conforming changes for LLCs and RBICs, subject to the $100 million invested test
- Proposed catch-all for *any* type of entity to cover all categories added to 501(a) and raised by commentators, subject to the $100 million invested test
  - Any institutional accredited investor, as defined in Rule 501(a) under the Advisers Act (17 CFR § 230.501(a)), of a type not listed in paragraphs (a)(1)(i)(A) through (I) or paragraphs (a)(1)(ii) through (vi).
  - Does not appear to include family offices.

Significant Comment Letters

- Several commenters noted that there is no change to the financial thresholds for accredited investors, which is the same as when adopted in 1983 (except for exclusion of principal residence).
  - 13% of households now qualify compared with 1.6% in 1983.
- Other commentators urged more action to expand retail access to private funds, either directly or by permitting registered funds of private funds.
  - Issue raised in 2019 concept release.

FAMILY OFFICE ISSUES AND CONSIDERATIONS

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Estate Planning for Hedge Fund Interests

Federal Transfer Tax System

- Annual Gifts: $15,000 annually to any number of recipients
- Direct payments of tuition and healthcare expenses
- Unlimited transfers to US citizen spouse
- Highest federal estate/gift tax rate: 40%
- Current federal estate/gift tax/generation-skipping transfer (GST) tax exemption: $11,580,000 per taxpayer
- Transfers to charity are not subject to tax

Goals

- Manage and transfer wealth in a tax-efficient manner
- Leverage use of the current exemptions

Assets on Which to Focus

- Assets likely to appreciate
- General Partner Interest (including the carry); management company; and any LP interests

Current Environment

(Looking at the "Silver Lining")

- Extraordinary opportunity due to historically low IRS intra-family interest rate
- Low valuations; opportunities for long-term growth

Considerations for New Investments

How to Remove Future Appreciation Outside of Estate Using Intra-Family Transfers (gifts, loans, sales) for a **New** Investment:

Irrevocable Grantor Trust.	Husband is hedge fund manager starting new fund. Wife creates new irrevocable trust for benefit of Husband and children with Husband as Trustee. Trust is grantor trust for federal income tax purposes (Wife pays income tax, not the trust). Wife makes a cash gift to trust which is covered by gift tax exemption and allocates GST exemption to gift on a gift tax return. Trust buys interest in a new entity which could be the GP of a fund. All trust assets outside of Husband's and Wife's taxable estates. If structured properly, assets will be outside of children's estates and not subject to transfer tax at each future generation.
Gift and Loan.	Husband hedge fund investor creates irrevocable grantor trust for benefit of Wife and children and makes a gift to the trust to which he allocates GST exemption on a gift tax return. Ideally, gift is subject to valuation discount if interest is nonmarketable and noncontrolling. Husband loans money to the trust; trust issues a long-term promissory note bearing **1.01%** interest. Trust buys limited partnership interest in the fund. The note receivable (which does not increase in value) and the 1.01% interest on loan will be included in Husband's taxable estate but all appreciation of fund and earnings on appreciation will be estate tax free in the trust.

Considerations for Existing Investments

How to Remove Future Appreciation Outside of Estate for **Existing** Investments:

Grantor Retained Annuity Trust ("GRAT").	Husband creates irrevocable trust ("zeroed-out") and retains right to receive fixed annuity payment over two or three years. At end of term, assets in trust continue in trust for Wife and children. If trust assets appreciate at a rate greater than **0.6%**, excess appreciation remains in trust gift and estate tax free.
Caution:	– Be wary of Internal Revenue Code section 2701 rules. To minimize risk, transfer "vertical slice" or a proportionate amount of all of the interests that Husband owns in existing fund. Trust receives pro rata share of all same interests that Husband had.
	– Consider whether GP carried interest is "vested."
	– Consider valuation risk exposure based on technique chosen.

General Recommendations

- Understand nature of assets to best manage transfer tax opportunities and implications
- Work closely with team of advisors so every member of team is on lookout for opportunities
- Start transferring assets early when values are low and regularly to extent cash flow allows

Family Office Considerations – Structure of Family Offices

- Are you seeing requests for clients to arrange your fees to be paid by a family office entity rather than the entity holding the assets? If so, we are going to explain what is behind the push for these changes.

General Structures for Family Offices

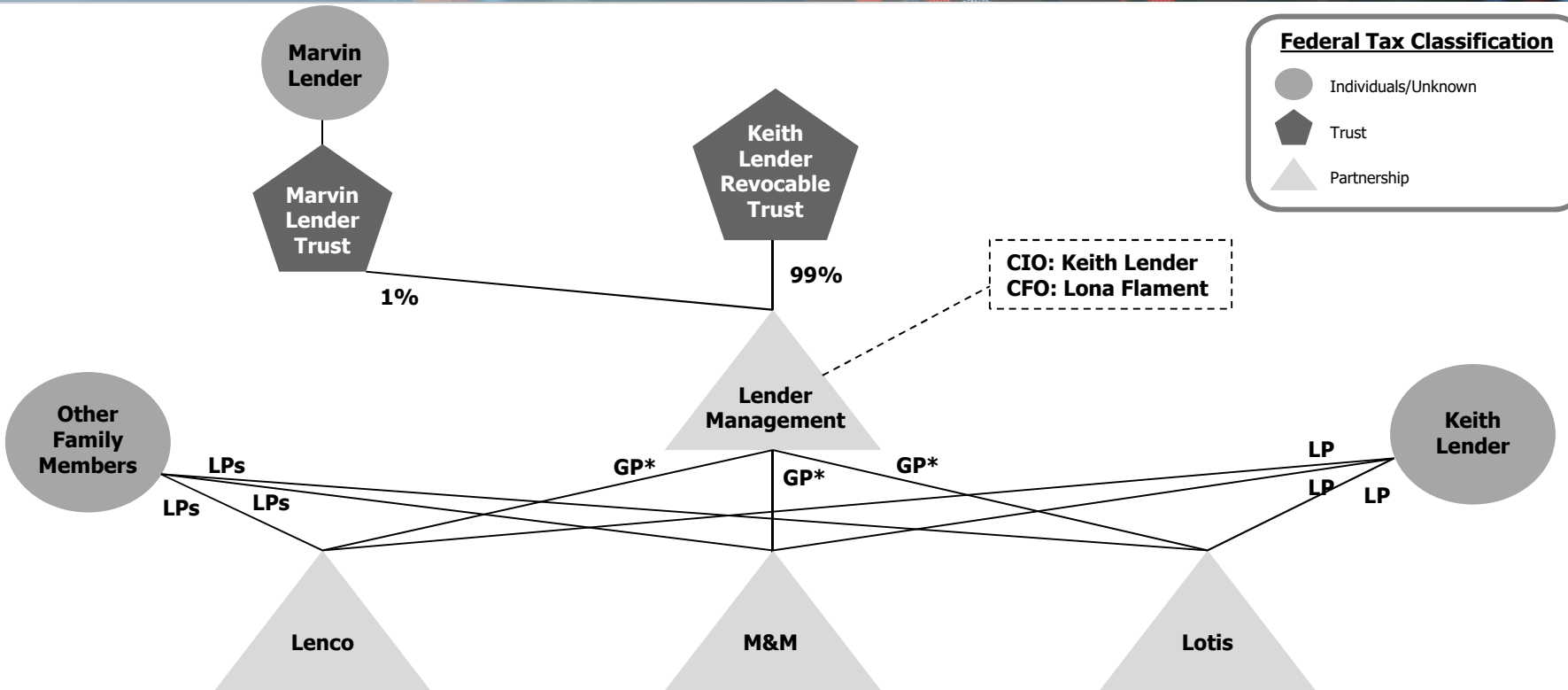
In General:

- G1 has a significant wealth event.
- G1 engages in estate planning for G2 and further generations that often consists of making of gifts, creating trusts and other planning.
- Economies of scale are often sought by bringing family members together to jointly invest in separately managed accounts or pooled investment vehicles.
- Family offices also provide:
  - (i) comprehensive financial planning;
  - (ii) portfolio management;
  - (iii) back office/consolidated reporting;
  - (iv) estate and wealth transfer planning;
  - (v) tax planning, preparation, and compliance;
  - (vi) risk management;
  - (vii) trustee services;
  - (viii) life management;
  - (ix) family consulting, governance, meetings and education; and
  - (x) strategic philanthropy and administration.

Deduction of Expenses

- History of Section 162 and 212
  - Engaging in a Trade or Business
  - Historic Limitations on Section 212
    - 2% Floor
    - Pease Limitations
    - AMT
  - 2017 TCJA changes

Lender Management



*Represents capital and profits interest

Lender Management LLC v. Comm'r

Overview

Tax Classification of Family Office/GP – LLC taxable as a partnership.

Tax Classification of Investment Entities – three separate LLCs taxable as partnerships.

Ownership of Family Office/GP – 99% by one G3 member and 1% by a G1 Trust.

Ownership of the Investment Entities – the 99% owner of the GP owned about 11% of the three LLCs.

Relationship of G3 Owner of GP to Other LPs – the family LLCs included members of G2, G3 and G4; only two of five family lines of G2 were investors; there was mention of the fact that the family member investors were geographically dispersed and rarely got together and, in fact, some would not meet with each other.

Lender Management LLC v. Comm'r

Overview

Withdrawal Rights – on demand, subject to liquidity restraints.	
Activities of the GP – GP performed extensive management activities.	Managed investments, investment LLCs and office personnel; researched and pursued new investment opportunities; reviewed about 150 PE and hedge fund proposals a year; managed other downstream entities which did not include family members (query if this violated their family office exemption); provided investment and financial planning services for individual members of LLCs; met with and attended presentations of hedge fund and private equity managers and investment bankers; entered into private equity deals and made hedge fund trades; conducted annual business meetings with each client; developed investment options to meet individual client needs; prepare monthly, quarterly and annual reports; interview and acquire outside investment and accounting firms for services.

Lender Management LLC v. Comm'r

Overview

Nature of Investments – 50% in private equity and balance in hedge funds and public equities.	
Third-party arms-length nature of compensation arrangement – charges a carried interest of 25% and a management fee of 2.5%.	The facts in the opinion regarding whether a management fee was charged after 2010 are unclear. Before 2010, the fee structures ranged from a management fee of 1-2% and a 5% carried interest.
GP Return on Investment and Fees – the court noted that compensation was based on the increase in value of assets.	
Relationship of Family Members and Employees of GP – employed five employees, including a CFO; the G3 majority owner of the GP had an MBA and investment-related experience.	

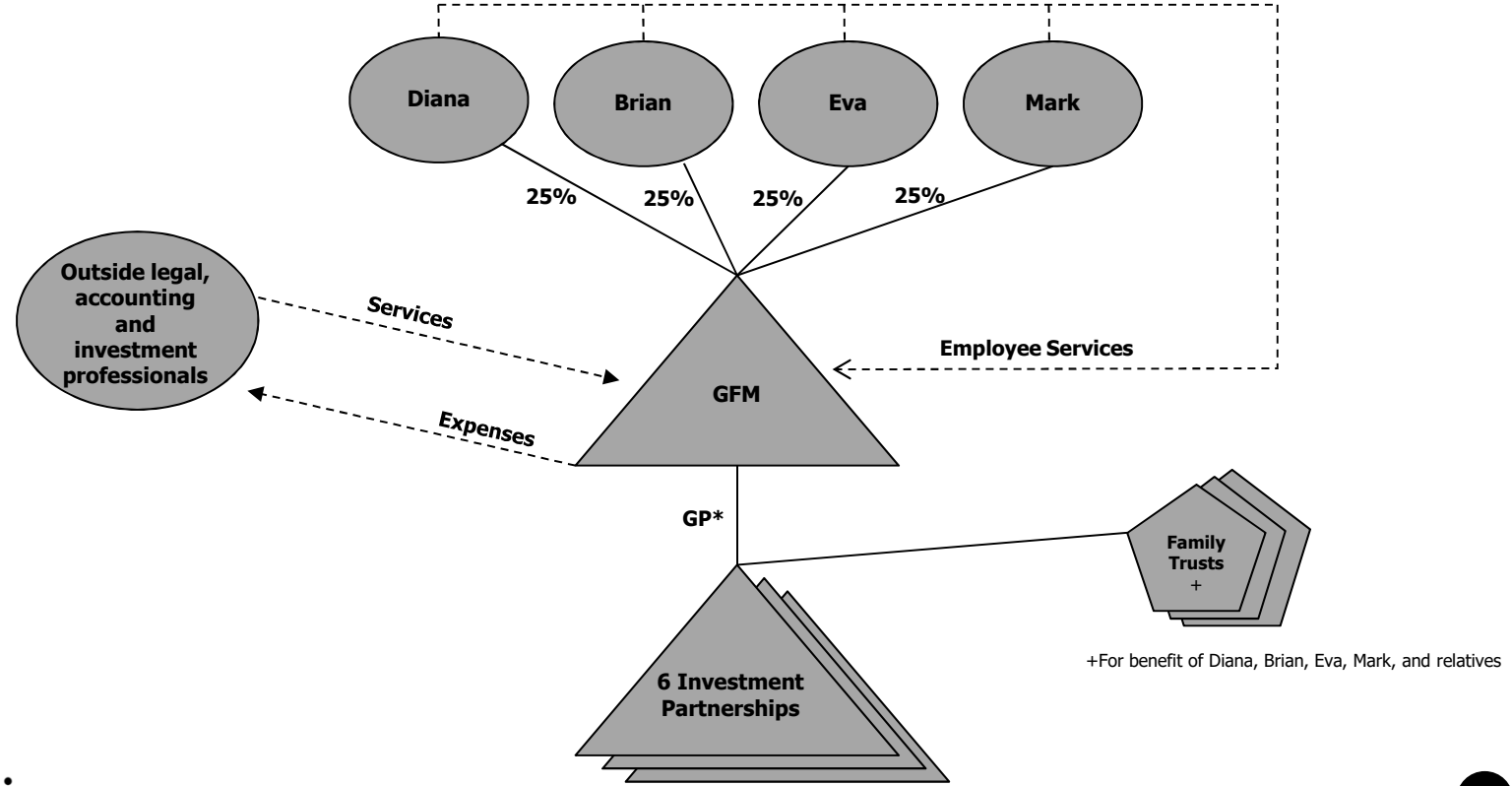
Lender Management LLC v. Comm'r

Overview

Compliance with Family Office Exemption to Registration as RIA – it is questionable whether the GP in *Lender* satisfied the family office exemption from registering as an RIA based on the notation that it provides "management services to…other third-party non-family members." It is unclear if this was a relevant fact taken into account by the *Lender* court.

Very generally, to qualify for the exemption, the family office (i) can only provide investment advice to "family clients"; (ii) ownership of the family office is limited to certain family members; (iii) control of the family office is restricted; and (iv) the family office cannot hold itself out to the public as an investment advisor.

Alternative is to register as an RIA but that would result in reporting of AUM by the Family Office which most families want to avoid.



+For benefit of Diana, Brian, Eva, Mark, and relatives

*Represents profits interest

Hellmann Facts

- GP was organized as an LLC taxable as a partnership. It was owned equally by a mother and her three children.
- Each of the four owners of the GP were paid salaries by the GP and served as officers of the GP with certain duties.
- GP received a profits interest from the investment partnerships – 15bps for a time-based profits interest based on AUM and 6% based on increase in value of assets.
- The investment partnerships were owned by trusts which were formed for the benefit of the four, who were also the trustees of the trusts.

Hellmann Facts

- Almost all expenses were paid to third-party investment advisors, accountants and lawyers.
- The Trusts could redeem at any time and the investment partnerships could liquidate upon request of LPs with GP consent.

Resolution of *Hellmann*

- In November 2018, the Hellmanns paid the tax originally set forth in the audit letter. No penalties were originally set forth in the audit.
  - Presumably, the bad facts and cost of litigation led to the abandonment by the taxpayer.

Takeaway from *Hellmann*

Clearly ownership of the GP and the Investment Partnerships matters the most. In differentiating *Lender*, the IRS took note that the *Lender* court said that the GP "…**primarily** provided [investment management services] to and for the benefit of clients other than itself" and that "…it was not managing its own money. **Most** of the assets under management were owned by members of the Lender family that had no ownership interest in [the GP]." Could there be a 50% rule here in structuring GP ownership?

IRS will apply heightened scrutiny to these family arrangements and will fight those ownership structures it views as going too far.

Family members should have outside sources of earned income.

Structuring of Family Offices

Lender is only a Tax Court Memorandum decision.

In both *Lender* and *Hellmann*, the GP was structured as an LLC taxable as a partnership. Consideration should be given to having the GP be taxable as a corporation (currently subject to tax rates of 21% under recent tax act) rather than an LLC, but need to consider possible application of personal holding company and accumulated earnings tax implications.

Ownership of GP and investment partnerships needs to be dispersed. The bigger the family of investors that do not own the GP, the better.

Attention to SEC exemption from registration as RIA is a necessity.

LIBOR TRANSITION AND DERIVATIVES UPDATE

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LIBOR Transition

- December 31, 2021
  - Some milestones moved due to COVID-19 but not the end date
- USD LIBOR switching to SOFR
- Other LIBORS/IBORS are switching to alternative rates
- SEC requires a plan and disclosure
- CFTC requires disclosure and has provided relief for the transition
- ARRC has furnished guidance and a template strategy to transition
- Know what you own/trade and how it can be altered

LIBOR Transition

- Updates
  - Treasury is contemplating an issuance of FRNs tied to SOFR and asked for comment
  - ARRC has published numerous consultations
    - Latest addresses aspects of the LIBOR to SOFR spread adjustment
  - Expectation for USD loans to switch to SOFR by 1Q 2021
  - Fannie/Freddie moving to SOFR based ARMs and will stop purchasing LIBOR based ARMs by the end of 2020
  - ARRC has proposed NY legislation to address legacy LIBOR contracts
  - ARRC has proposed technology vendor readiness checklist
  - The Fed is publishing SOFR averages and a SOFR index
  - CME and LCH to adjust discounting to use SOFR for derivatives in October 2020

ISDA Developments – ISDA Clause Library

- ISDA recognizes the current lack of standardization in ISDA documentation gives risk to operational inefficiencies, unsustainable costs, and legal and operational risk.
- To address these issues, ISDA has created the **ISDA Clause Library Project** to identify provisions within trading documents that might benefit from further standardization.
- The goal is for highly negotiated and problematic terms to be defined, categorized, and standardized, such as Termination Currency, Automatic Early Termination, Payment Netting, and Setoff clauses.

ISDA Developments – ISDA Clause Library

- Benefits to the standardization and digitization of these provisions include:
  - More efficient/quicker contract negotiation and client onboarding;
  - Creation of an industry-standard framework for managing and categorizing the data in these trading agreements;
  - More accurate and consistent reporting of data as required by regulations;
  - Easier ability to recognize terms in documentation for operational purposes; and
  - More efficient opportunities to repaper or amend documents due to market or regulatory requirements.

Proposed CFTC Position Limits on Physical Commodity Derivatives: Historical Overview

2010:

The first notice of proposed rulemaking was issued in 2010 and was subsequently withdrawn.

2011-2012:

The second notice was issued, and the rules adopted, in 2011, but ultimately the rules were vacated by the US District Court for the District of Columbia because the court found that there were at least two plausible readings of the Act and, therefore, the court did not uphold the CFTC's interpretation of the statutory requirements regarding the imposition of position limits.

2013:

The Commission issued a third notice, relating to aggregation of positions, and a fourth notice, relating to reproposed position limits. The Commission then issued a revised reproposal pertaining to aggregation of positions and federal position limits, and adopted final rules on aggregation of positions.

2016:

The Commission issued a supplemental rulemaking and a revised reproposal of its position limits regime.

2020:

The Commission issued a new proposal replacing prior proposals. The comment period closed on May 15, 2020.

25 Core Referenced Futures Contracts

Core referenced futures contracts, which are 25 physically settled agricultural, metals, and energy futures and options on futures contracts.

** Indicates contracts that are currently subject to federal position limits. Other contracts would be newly subject to federal position limits.*

Other Referenced Contracts

- **Linked contracts**, which include futures and options on futures contracts that are directly or indirectly linked to the price of a core referenced futures contract, or to the same commodity underlying a core referenced futures contract for delivery at the same location as specified in that core referenced futures contract
  - To provide market participants with greater clarity as to which contracts may be included in the scope of linked contracts, CFTC staff will publish and periodically update a CFTC Staff Workbook that will provide a nonexclusive list of linked contracts. In this context, an example of "indirect linkage" would include cash settled futures contracts or options on futures that settle to a referenced contract.

Other Referenced Contracts

- **Economically equivalent swaps**, which include swaps with identical material contractual specifications, terms, and conditions to a referenced contract.
- The definition of economically equivalent swaps is narrower than the linked contracts definition.
- For economically equivalent swaps, identical material contractual specifications, terms and conditions include a comparison of terms relating to the underlying commodity (commodity reference price and grade differentials) and the settlement method (physical vs. cash settlement), but disregard any differences between a swap and a referenced contract due to:
  - notional amount or lot size,
  - post-trade risk management (e.g., cleared vs. not cleared, or margin terms), or
  - for physically settled swaps, delivery dates diverging by less than one calendar date, except in the case of physically settled natural gas swaps, where delivery dates may diverge by less than two calendar days (which will capture penultimate natural gas swaps within the economically equivalent swap definition).
- The proposal says that this definition is generally consistent with the EU definition, with the exception that the CFTC definition refers to "identical *material* terms."

Contracts *Not* Included

- Under the proposal, referenced contracts would *not* include location basis contracts, commodity-index contracts, swap guarantees, and trade options that meet the requirements of CFTC Regulation 32.3.

Spot Month Limits

- All 25 core referenced futures contracts are subject to spot-month limits
- **Limit levels.** The proposed limit levels (see table that follows) are generally higher than the existing CFTC (for agricultural contracts) and exchange-set (for energy and metals) position limits for these contracts.
- **Spot month versus non-spot month.** Other than the nine legacy agricultural contracts (where the proposal includes any and all month limits), the proposed limits are only for the spot month.

Non-Spot Month Limits

- The proposal adopts federal "single month" and "all months combined" non–spot month position limits (referred to as "non–spot month limits") only for referenced contracts based on the nine legacy agricultural contracts that are currently subject to federal position limits.
- For physical commodity contracts not subject to federal limits, exchanges would generally be required to set spot month limits no greater than 25 percent of deliverable supply, but would have flexibility to submit other approaches for CFTC review. Exchanges would have more flexibility in setting limits or accountability levels outside of the spot month.
- Legacy ag contracts are subject to single-month and all-months-combined limits.
- The federal single-month and all-months-combined limits will be the same.
- These non–spot month limits would permit netting of all positions in referenced contracts (regardless of whether such referenced contracts were physical delivery or cash settled) when calculating a trader's positions for purposes of the proposed non–spot month limits.

Proposed Federal Limits

Agricultural

Contract	Proposed Spot Month Limit	Proposed Any/All Month Limit
Legacy agricultural		
CBOT Corn (C)	1,200	57,800
CBOT Oats (O)	600	2,000
CBOT Soybeans (S)	1,200	27,300
CBOT Soybean Meal (SM)	1,500	16,900
CBOT Soybean Oil (SO)	1,100	17,400
CBOT Wheat (W)	1,200	19,300
CBOT KC Hard Red Winter Wheat (KW)	1,200	12,000
MGEX Hard Red Spring Wheat (MWE)	1,200	12,000
ICE Cotton No. 2 (CT)	1,800	11,900
Other agricultural		
CBOT Rough Rice (RR)	800	N/A
CME Live Cattle	600/300/200 *(step down over spot period)*	N/A
ICE Cocoa (CC)	4,900	N/A
ICE Coffee C (KC)	1,700	N/A
ICE FCOJ-A (OJ)	2,200	N/A
ICE U.S. Sugar No. 11 (SB)	25,800	N/A
ICE U.S. Sugar No. 16 (SF)	6,400	N/A

Metals

Contract	Proposed Spot Month Limit	Proposed Any/All Month Limit
COMEX Copper (HG)	1,000	N/A
COMEX Gold (GC)	6,000	N/A
COMEX Silver (SI)	3,000	N/A
NYMEX Palladium (PA)	50	N/A
NYMEX Platinum (PL)	500	N/A

Energy

Contract	Proposed Spot Month Limit	Proposed Any/All Month Limit
NYMEX Henry Hub Natural Gas (NG)	2,000* *(see conditional limit, above)*	N/A
NYMEX Light Sweet Crude Oil (CL)	6,000/5,000/4,000 *(step down over spot period)*	N/A
NYMEX New York Harbor ULSD Heating Oil (HO)	2,000	N/A
NYMEX New York Harbor RBOB Gasoline (RB)	2,000	N/A

Spot Month Limits

Core Referenced Futures Contract	2020 Proposed Spot Month Limit	Existing Federal Spot Month Limit	Existing Exchange-Set Spot Month Limit
Legacy Agricultural Contracts			
CBOT Corn (C)	1,200	600	600
CBOT Oats (O)	600	600	600
CBOT Soybeans (S)	1,200	600	600
CBOT Soybean Meal (SM)	1,500	720	720
CBOT Soybean Oil (SO)	1,100	540	540
CBOT Wheat (W)	1,200	600	600/500/400/300/220
CBOT KC Hard Red Winter Wheat (KW)	1,200	600	600
MGEX Hard Red Spring Wheat (MWE)	1,200	600	600
ICE Cotton No. 2 (CT)	1,800	300	300

Spot Month Limits

Core Referenced Futures Contract	2020 Proposed Spot Month Limit	Existing Federal Spot Month Limit	Existing Exchange-Set Spot Month Limit
Other Agricultural Contracts			
CME Live Cattle (LC)	600/300/200	n/a	450/300/200
CBOT Rough Rice (RR)	800	n/a	600/200/250
ICE Cocoa (CC)	4,900	n/a	3,000
ICE Coffee C (KC)	1,700	n/a	500
ICE FCOJ-A (OJ)	2,200	n/a	300
ICE U.S. Sugar No. 11 (SB)	25,800	n/a	5,000

Spot Month Limits

Core Referenced Futures Contract	2020 Proposed Spot Month Limit	Existing Federal Spot Month Limit	Existing Exchange-Set Spot Month Limit
Metals Contracts			
COMEX Gold (GC)	6,000	n/a	3,000
COMEX Silver (SI)	3,000	n/a	1,500
COMEX Copper (HG)	**1,000**	**n/a**	**1,500**
NYMEX Platinum (PL)	**500**	**n/a**	**500**
NYMEX Palladium (PA)	**50**	**n/a**	**50**
Energy Contracts			
NYMEX Henry Hub Natural Gas (NG)	2,000	n/a	1,000
NYMEX Light Sweet Crude Oil (CL)	6,000/5,000/4,000	n/a	3,000
NYMEX New York Harbor ULSD Heating Oil (HO)	2,000	n/a	1,000
NYMEX New York Harbor RBOB Gasoline (RB)	2,000	n/a	1,000

Non-Spot Month Limits

(Single Month and All Months Combined Limits)

Core Referenced Futures Contract	2020 Proposed Single Month and All Months Limit	Existing Federal Single Month and All Months Limit	Existing Exchange-Set Single Month and All Months Limit
Legacy Agricultural Contracts			
CBOT Corn (C)	57,800	33,000	33,000
CBOT Oats (O)	2,000	2,000	2,000
CBOT Soybeans (S)	27,300	15,000	15,000
CBOT Soybean Meal (SM)	16,900	6,500	6,500
CBOT Soybean Oil (SO)	17,400	8,000	8,000
CBOT Wheat (W)	19,300	12,000	12,000
CBOT KC Hard Red Winter Wheat (KW)	12,000	12,000	5,000
MGEX Hard Red Spring Wheat (MWE)	12,000	12,000	12,000
ICE Cotton No. 2 (CT)	11,900	5,000	5,000

Conditional Spot Month Limit for Natural Gas

- The proposal would establish a conditional spot-month limit only for Henry Hub natural gas referenced contracts that will permit traders to acquire position levels in cash-settled contracts that are five times the spot-month limit for such contract (2,000 contracts) per DCM (and in economically equivalent swaps) if such positions are exclusively in cash-settled contracts and provided that:
  - for cash-settled contracts in the spot month, the trader does not hold or control positions in cash-settled contracts in the spot month that exceed the conditional position limit (10,000 contracts net long or short per DCM *plus* 10,000 contracts in economically equivalent swaps); and
  - the trader does not hold or control any positions in the physical-delivery natural gas referenced contract in the spot month.

Implementation Challenge

- Are the definitions of linked contracts and economically equivalent swaps sufficiently precise to allow traders and compliance staff to know with certainty which contracts must be aggregated for speculative position limits?
- How will traders monitor their swaps activities to capture economically equivalent swaps?
- Notably, the proposal states:
  - Because settlement type would be considered to be a material "contractual specification, term, or condition," a cash-settled swap could only be deemed economically equivalent to a cash-settled referenced contract, and a physically settled swap could only be deemed economically equivalent to a physically settled referenced contract; however, a cash-settled swap that initially did not qualify as "economically equivalent" due to no corresponding cash-settled referenced contract (i.e., no cash-settled look-alike futures contract), could subsequently become an "economically equivalent swap" if a cash-settled futures contract market were to develop.
  - In addition, a swap that either references another referenced contract or incorporates its terms by reference would be deemed to share identical terms with the referenced contract, and therefore would qualify as an economically equivalent swap.
- Explaining the last sentence, the proposal states: "For example, a cash-settled swap that either settles to the pricing of a corresponding cash-settled referenced contract, or incorporates by reference the terms of such referenced contract, could be deemed to be economically equivalent to the referenced contract."

Practical Considerations

- This is the first time swaps and futures will be aggregated for purposes of position limits.
  - Operationally, how will your firm aggregate futures and swaps?
  - Can you do this on a global scale taking into account exchange-imposed limits and limits tracked across exchanges under the CEA and ESMA?
  - How will you determine which swaps are economically equivalent swaps?
- Is the most significant barrier to effective position limit monitoring access to data, both in terms of capturing the data and consolidating it?

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Katherine Dobson Buckley focuses her practice on the application of derivatives in trading, legal, and regulatory issues. She represents hedge funds, investment advisors, mutual funds, endowments and other market participants in complex cross-border and US futures, derivatives, prime brokerage, custodial, and commodities transactions.

Katherine has experience with International Swaps and Derivatives Association Master Agreements (ISDAs), Prime Brokerage Agreements, Master Repurchase Agreements (MRAs), Master Securities Loan Agreements (MSLAs), and Master Securities Forward Transaction Agreements (MSFTAs), as well as clearing, custody, options and futures account agreements, and related trading documentation. She also advises financial firms and other market participants on US and cross-border regulatory issues, including registration and exemption requirements with the US Commodity Futures Trading Commission (CFTC) and requirements of the Dodd-Frank Act provisions applicable to derivatives transactions.

Katherine spent time on secondment at the general counsel division of Credit Suisse, where she negotiated sophisticated derivative transactions. Katherine also worked as a law clerk for the US Securities and Exchange Commission, researching regulatory and securities fraud issues.

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Thomas V. D’Ambrosio concentrates his practice on structured and complex derivative transactions, including related insolvency and regulatory issues. Thomas helps clients structure, negotiate, and analyze the risk inherent in a wide range of cleared and uncleared derivative and futures products. He represents clients in all asset classes, including equity, debt, credit, commodity, interest rate, currency, and exotic derivatives. His clients include Fortune 500 corporations, private companies, investment managers, hedge funds, financial institutions, pension funds, and high net-worth individuals.

Thomas is particularly active in advising enterprises that employ derivatives to hedge risks, monetize assets, and finance the acquisition of assets on favorable terms—with and without the benefits of leverage—including financing issuer equity and debt repurchase programs. He actively represents clients on LIBOR reform and Dodd–Frank derivative reform.

Thomas also represents issuers in public and private sales of equity and debt securities. He advises purchasers and sellers in stock sales, asset sales, and merger transactions; counsels investment managers in leveraged private fund investments; and advises pension fund managers and wealthy families with respect to their investments in private funds.

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Christina Mesires Fournaris advises clients on estate, tax, and generational wealth planning. High-net-worth individuals, multigenerational family groups, entrepreneurs, and owners of privately held businesses are among her clients. A significant portion of her time is devoted to working with women business owners, as well as women who control their family's wealth. Her practice includes advising clients on trusts, tax planning, philanthropic and charitable giving, and estate planning.

When working with families, Christina counsels family groups and family offices on the management of their holdings and management of trusts that represent family members. When she facilitates a family meeting, Christina helps the family develop a mission statement. She also educates family members on the importance of trusts, and the tax and investment considerations for various family trusts.

In her work with business owners, Christina counsels them before major liquidity events. She also structures transfer tax vehicles to shift wealth to the next generation in a tax-efficient manner.

Christina also works with individual and corporate fiduciaries on trust and estate administration matters, including counseling clients on best practices, as well as federal and state fiduciary income tax implications. She also advises clients on charitable planning techniques, including major planned gifts of various assets, charitable trusts, and private foundations.

She frequently speaks to audiences that include insurance, financial, and investment professionals and advisers.

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Amy Natterson Kroll counsels US and non-US financial institutions on US regulatory requirements and best practices related to broker and dealer activities. Clients seek Amy's advice on, among other things, issues related to implementation of new regulations; the acquisition and sale of broker-dealers; expansion of business and related regulatory requirements for financial institutions; and regulations related to the capital markets, such as research activities and research analysts, supervisory controls and internal controls, and cross-border securities activities. Amy also advises clients on the collateral consequences of enforcement, civil, and criminal actions. She has a specific interest in the issues central to regional full-service and mid-market broker-dealers.

Amy worked at the Securities and Exchange Commission twice. From 1997–1998 she was assistant general counsel (legislative and financial services) at the SEC, to which she had returned after five years in private practice counseling broker-dealers and other financial institutions. From 1984–1991, during her first tour of SEC service, she served in positions of increasing responsibility, first as an attorney-adviser in the division of Market Regulation (now the division of Trading & Markets), and subsequently as counsel to Commissioner Edward H. Fleischman and as senior special counsel in the division of Corporation Finance, Office of International Corporate Finance.

From 1998–2003, Amy was an independent consultant, focusing on issues confronted by non-US financial entities seeking to engage in broker-dealer activities in the United States. During that time, she also taught at the Washington College of Law, American University.

Amy serves as the Washington office practice group leader for the firm's investment management practice and also is the Washington office hiring partner. She previously served as a member of the NASDAQ Market Operations Committee. Prior to joining Morgan Lewis, Amy was a partner in the financial institutions regulatory, enforcement, and litigation practice at another international law firm.

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Michael M. Philipp counsels financial services clients in futures and securities transactions. He also advises them in derivatives regulation, legislation, compliance, and enforcement matters. United States and foreign exchanges and clearing organizations, banks, investment managers, proprietary trading firms, brokerage firms, and end users turn to Michael for guidance in connection with exchange-traded and over-the-counter derivative instruments. He also represents foreign exchanges and clearinghouses in their US offerings of futures and equity options products and derivatives clearing activities.

Michael has experience working with clients on issues related to the Dodd–Frank Wall Street Reform and Consumer Protection Act, as well as US Commodity Futures Trading Commission (CFTC) registration and compliance-related issues. These issues include trade practices, swap reporting and clearing, registration of swap execution facilities (SEFs), futures exchanges, clearing organizations, and swap data repositories (SDRs); retail and eligible contract participant forex (ECP FX) transactions; and futures commission merchant (FCM), swap dealer, commodity pool operator (CPO) and commodity trading advisor (CTA) registrations and compliance. Michael has experience in conducting internal compliance investigations, as well as representing clients in exchange and CFTC inquiries and proceedings, including matters involving allegations relating to disruptive trading practices, such as spoofing and market manipulation. He also provides assistance to firms that are negotiating bilateral and cleared swap documentation.

Before joining Morgan Lewis, Michael worked as an in-house attorney for the Chicago Mercantile Exchange (CME). There he served as counsel to the CME's regulatory trade practice, compliance, and arbitration committees.

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Before joining Morgan Lewis, David was associate director for international corporate finance in the Division of Corporation Finance at the SEC. In that position, he developed SEC policy on cross-border offerings, acquisitions, and listings, which included offshore Internet offerings, international disclosure and accounting standards, and international corporate governance guidelines. David also advised the SEC and its Division of Enforcement on financial fraud cases and cross-border offering abuses. Earlier, he served as senior legal advisor to the SEC's director of the Division of Corporation Finance, and as staff director of the Advisory Committee on Capital Formation and Regulatory Processes. He also served for seven years as chief of the division's Office of Tender Offers, administering rules on M&A, going private transactions, and proxy contests.

David is a former vice-chair of the ABA Federal Regulation of Securities Committee and a former chair of the ABA Subcommittee on Corporate Disclosure. He also served as a member of the FINRA Corporate Financing Committee. He speaks frequently at conferences and continuing legal education programs on public and private financings, corporate reporting and governance, M&A, and private fund regulation.

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Bill is the most recent past chair of the investment management committee of the tax section of the American Bar Association. He is a frequent speaker on tax-related topics, and also annually presents at Morgan Lewis's Private Fund Investor Roundtable. In addition, Bill is a fellow of the American College of Tax Counsel.

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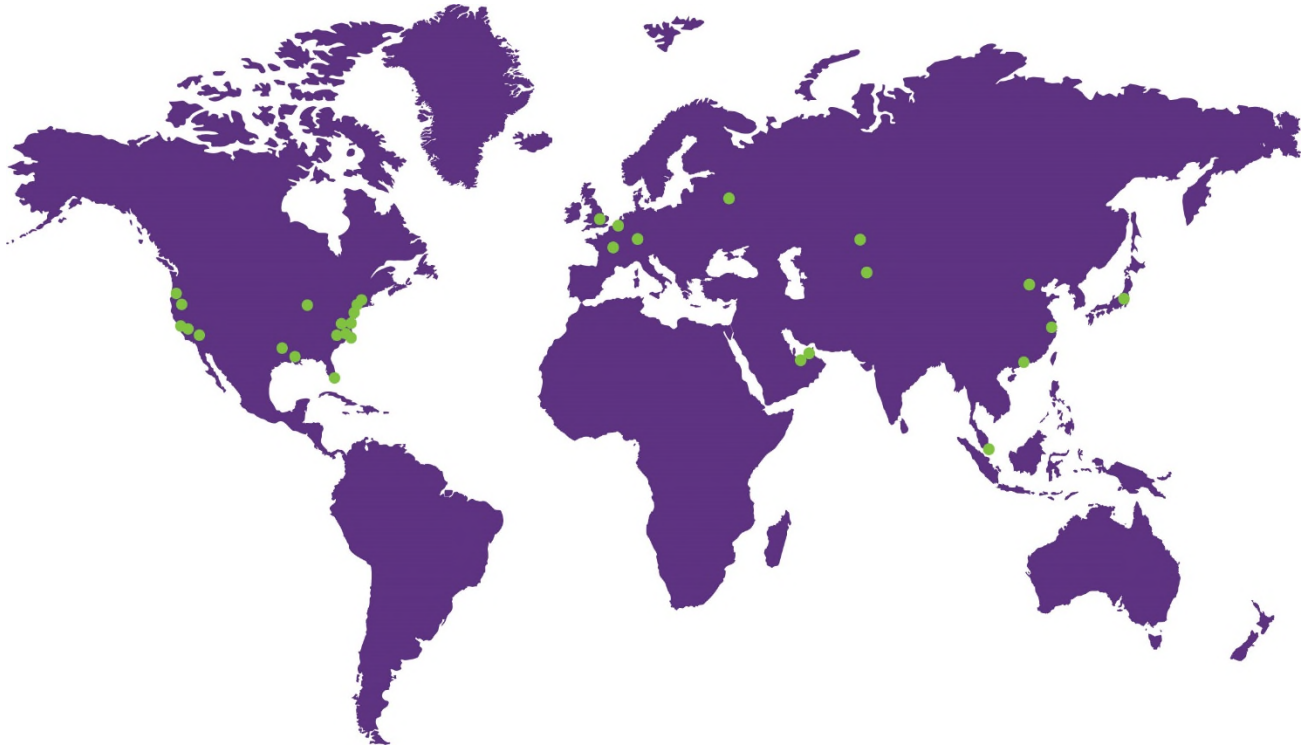

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