FUTURES 101

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I. Introduction

This paper provides a general overview of the markets for futures and options on futures ("***futures markets***") and regulation of those markets in the U.S. under the Commodity Exchange Act ("***CEA***") and the rules of the Commodity Futures Trading Commission ("***CFTC***"). Although this paper focuses on the futures markets, for context, it also briefly covers swaps and other transactions regulated under the CEA.

As this paper is for a "101" level panel on futures, it describes the futures markets and how they are regulated in basic terms. Things are more complicated than the high-level descriptions convey. The statutory provisions and CFTC rules governing futures exchanges and clearing houses, futures industry professionals, and futures market users are detailed in the obligations they impose, may contain exclusions or exemptions, and can raise issues of interpretation, which are beyond the scope of this paper. In addition, the exchanges, clearing houses and National Futures Association, as self-regulatory organizations, have rules that are also part of the overall CEA regulatory framework. FIA L&C 2021-V is offering other panels that cover in greater depth a number of the topics touched on in the Futures 101 panel and this paper.

II. The Basic Elements of the Futures Markets

A. **The Contracts: Futures and Options on Futures**. Futures and options on futures are types of derivatives that trade on exchanges. In simple terms, a derivative is a contract whose value is based on, or derived from, the price or value of a referenced asset (or the economic consequences of an event). A futures contract is an agreement where the parties promise to buy or sell a particular asset such as corn or U.S. Treasury securities at a specified future date and at the price established at the time of the trade. An option on a futures contract is an agreement that gives the holder the right to buy or sell a specific futures contract from or to the option seller at a pre-determined price, on or before a specified expiration date. Futures and options on futures have standardized terms to facilitate their trading on exchanges. Exchanges list futures contracts for different delivery or expiration months and options covering futures for different delivery months and for different strike prices.

B. **Futures Exchanges**. Futures exchanges, such as the Chicago Mercantile Exchange or ICE Futures U.S., operate futures markets. The CEA, in fact, requires transactions in derivatives that are futures or options on futures to occur on or subject to the rules of an exchange. The exchanges operate centralized auction markets where buyers and sellers trade with one another, typically on an anonymous basis. U.S. exchanges are "designated contract markets" ("***DCMs***") under the CEA. Futures exchanges located outside the U.S., such as the London Metal Exchange or Eurex, are "foreign boards of trade" ("***FBOTs***") under the CEA.

C. **Clearing Houses**. Parties to futures and options on futures trades have obligations to perform in the future under their contracts. To assure that they perform their obligations,

all transactions in futures or options on futures contracts are submitted to a clearing house, called a derivatives clearing organization ("***DCO***") under the CEA, for clearing and settlement. The parties must use the clearing house designated by the exchange. When a trade is accepted for clearing, the clearing house is inter-positioned between the original parties to the trade as the "central counterparty." Persons with open positions must post collateral, called margin, to secure or guarantee that they will perform their obligations on their cleared transactions.

D. **Futures Market Intermediaries**. A market participant typically opens an account with a futures broker called a futures commission merchant ("***FCM***") to access the exchange markets and their clearing houses. Other types of market professionals also provide services to customers with respect to the futures markets.

E. **Market Participants**. Investors trade futures and options on futures to speculate on changes in the price or value of the underlying asset. Many businesses use futures and options on futures to hedge against the risk of such changes. (Investors and businesses also use swaps for these purposes.)

III. The Basic Elements of the Futures Regulatory Framework

A. **The Statute: Commodity Exchange Act ("*CEA*")**. The CEA is the U.S. federal statute that regulates futures markets, futures industry professionals, and futures market participants. It also regulates other types of derivatives transactions (notably, swaps) and certain leveraged retail transactions (which may be, but are not necessarily, derivatives).

B. **The Primary Regulator: Commodity Futures Trading Commission ("*CFTC*")**. The CFTC is an independent agency of the federal government, formed in 1975. It is responsible for implementing the CEA and is the primary (but not only) federal agency authorized to regulate derivatives markets, including the futures markets, futures industry professionals, and futures market participants.

C. **Allocation of Jurisdiction between the CFTC and Securities and Exchange Commission ("*SEC*") Over Securities-Related Futures and Options**. The SEC, and not the CFTC, regulates options on securities and securities indices pursuant to authority under the federal securities laws. In contrast, the CFTC, not the SEC, regulates futures and options on futures on "exempted securities" such as U.S. Treasury securities (but excluding municipal securities)[1] and on broad-based indices of other types of securities.[2] The CFTC and SEC, though, jointly regulate futures and options on futures on individual equity securities or

[1] "Exempted security" is defined in Section 3(a)(12) of the Securities Exchange Act of 1934 and includes U.S. government securities, municipal securities and certain other securities. It also includes foreign government debt securities enumerated in SEC Rule 3a12-8, which the SEC has agreed to classify as exempted securities for purposes of allowing trading of futures on such foreign government debt securities.

[2] There is also an allocation of jurisdiction between the CFTC and SEC with respect to securities-related swaps. The SEC regulates swaps based on an individual security other than an exempted security (with the exception of municipals securities) or on a narrow based index of such non-exempted securities as security-based swaps. The CFTC regulates swaps on an exempted security (excluding municipal securities but including a foreign government debt security enumerated in SEC Rule 3a12-8) or a broad-based index of non-exempted securities as swaps.

other securities that are not exempted securities (with the exception of municipal securities) and on narrow-based indices of such non-exempted securities, as "security futures products."

D. **Self-Regulatory Organizations ("*SROs*")**. The CEA incorporates self-regulation as an important part of the regulatory framework. The SROs perform their self-regulatory functions subject to the CFTC's oversight.

1. **National Futures Association ("*NFA*")**. NFA is a "registered futures association" and serves as an umbrella SRO for FCMs and other industry professionals that are required to register with the CFTC. Such persons are required to join NFA (with limited exceptions).

2. **DCMs and DCOs.** DCMs and DCOs are also SROs, with obligations to monitor and enforce compliance with their rules. DCMs must have jurisdiction over all persons trading on their markets, which they typically assert via rules that deem a market participant to consent to the exchange's jurisdiction by virtue of trading on the exchange's markets. DCOs have jurisdiction over their clearing members; clearing members typically consent to the DCO's rules and jurisdiction by signing a clearing membership agreement.

IV. Some Condensed History of the CEA

A. **1922**: The CEA dates back to the Grain Futures Act of 1922. The statute was limited in scope to futures on specific identified agricultural commodities, namely, wheat, corn, oats, barley, rye, flax and sorghum. Thus, federal regulation of agricultural futures markets pre-dates federal regulation of securities markets, which commenced with the Securities Act of 1933 and Securities Exchange Act of 1934.

B. **1936**: The CEA's name comes from the Commodity Exchange Act of 1936. The statute expanded the range of futures contracts subject to federal regulation through an expanded definition of "commodity" that included the grains listed in the Grain Futures Act, along with cotton, rice, mill feeds, butter, eggs and Irish potatoes.

C. **1936 to 1968**: Congress amended the CEA several times over this period to expand further the list of agricultural commodities covered by the "commodity" definition (and, along the way, to ban futures trading on onions by excluding onions from the definition). The CEA's historical linkage to the agricultural markets explains why the CEA contains certain seemingly anomalous provisions that single out futures or other derivatives involving agricultural commodities for special treatment.

D. **1974**: Congress passed the Commodity Futures Trading Commission Act of 1974 to amend the CEA to greatly expand the statute's reach to cover futures markets beyond those for futures on a list of enumerated agricultural commodities, by adopting a broad open-ended definition of the term "commodity." Notably, in light of this substantially expanded scope, the amendments authorized the establishment of the CFTC as an independent federal agency to administer the CEA, as successor to the Department of Agriculture and Commodity Exchange Commission.

E. **1982/1983**: The Futures Trading Act of 1982 (enacted in January 1983) amended the CEA and federal securities laws to allocate jurisdiction between the CFTC and SEC over options, futures, and options on futures involving securities or indices of securities, but initially banned security futures products. It also amended the CEA to require futures industry professionals to belong to a self-regulatory organization that is registered with the CFTC as a registered futures association, and added Section 17 to the CEA setting out the standards and requirements for an association to register with the CFTC in that capacity.

F. **2000**: The Commodity Futures Modernization Act of 2000 added broad exclusions and exemptions to the CEA covering bilateral over-the-counter ("***OTC***") transactions in derivatives commonly called swaps, to carve out such transactions from potential regulation under the CEA as futures. It also amended the CEA to modify the process for registering futures exchanges (as designated contract markets), created a new registration category for clearing houses (derivatives clearing organizations) and adopted a more principles-based approach for regulating the exchanges and clearing houses. It also established the framework for allowing trading of security futures products subject to joint oversight of the CFTC and SEC.

G. **2010**: The Dodd-Frank Act of 2010 marked a drastic shift from key policies encoded into the CEA in 2000. Notably, Dodd-Frank eliminated the exclusions and exemptions for swaps, and took the further significant step of amending the CEA to impose a comprehensive regime for regulating swaps,[3] moving the CEA far beyond its traditional focus on futures. The Dodd-Frank amendments to the CEA also expanded the requirements imposed on exchanges and clearing houses, shifting to a more prescriptive regulatory approach.

V. Why are Futures Markets Regulated?

A. Futures markets centralize trading interest and can provide price discovery that commercial parties rely upon for pricing their commercial contracts. Congress considers the price discovery function, along with the use of futures markets for hedging by businesses, as activities that are in the public interest, and they have formed the public interest justification for regulating futures markets since 1922.

B. To protect and foster the public interest uses of the futures markets, a primary goal of the CEA is to protect the futures markets and related cash markets from manipulation, unwarranted price distortions and congestion in deliverable supplies. The latter is important for futures contracts that settle by physical delivery of a commodity when parties hold their contracts to expiration.

VI. Futures and Options on Futures and Commodities

A. What is a Futures Contract?

1. The CEA does not provide formal definitions for the terms "futures contract" or "futures" in the statute's definitions section, CEA § 1a. Instead, the definitional elements

[3] Dodd-Frank also amended the federal securities laws to impose a comprehensive regime for regulating security-based swaps by the SEC.

are found in the CEA's grant of jurisdiction to the CFTC to regulate futures, set out in CEA § 2(a)(1). Under that provision, futures contracts are "contracts of sale of a commodity for future delivery." CEA § 1a does, though, define what the term "future delivery" means or, more accurately, what it does not mean. That definition and CEA § 2(a)(1) together form the basis for the forward contract exclusion described below from regulating commercial merchandizing transactions as futures.

2. In light of the exchange-trading requirement for futures noted above, futures are exchange-listed contracts, and normally have standardized terms established by the exchanges to facilitate trading on the centralized markets that the exchanges operate. When two parties enter into a futures contract, they are entering into a promise to buy or sell a specified quantity of a particular commodity at a date in the future, at the price established at the time of the trade.

3. The exchanges define the contract terms and conditions for the contracts they list for trading, *e.g.*, corn that meets certain grading standards and is deliverable at one of several locations, and the standard size or quantity represented by a single futures contract, *e.g.*, 1 corn futures contract equals 5,000 bushels of corn. Exchanges list futures for trading for different expiration or delivery months with a specified last trading date, and may list multiple expiration or delivery months concurrently for trading. The earliest delivery month listed for trading is generally referred to as the "front" or "spot" month contract. When a contract nears expiration, the futures prices and prices for the underlying commodity should converge.

4. The exchange will specify as part of the standardized terms and conditions for a particular futures contract whether final settlement under the contract is accomplished by delivery of and payment for the underlying commodity or by settling up gains and losses via a cash payment. For physical delivery contracts, the exchange establishes a process for matching short position holders (sellers) with long position holders (buyers). Typically, a short may initiate the delivery process any time during a period of days designated by the exchange, which normally fall within the delivery month but could commence shortly before the delivery month. The clearing house then assigns a delivery to a person holding a long position and the matched long and short parties have a bi-lateral delivery obligation between them. As a general matter, market participants that still hold open positions after the close of trading on the last trading day in the delivery month will be paired together (longs and shorts) for delivery.

5. The exchange will also prescribe the method for completing the delivery between the long and short parties. For nonfinancial commodities (*e.g.*, corn or gold), the parties typically fulfill their delivery obligations by tendering warehouse receipts or other title documents for the commodity (often in electronic form) in exchange for payment in full, often through their FCMs and the clearing house. Delivery could, though, involve actual load-out or transfer of the nonfinancial commodity itself.

6. Because futures contracts are legally binding promises to perform in the future, a person may sell (go short) a futures contract without owning the underlying commodity at the time of the trade. The nature of a futures contract also means that there is not a fixed or finite number of futures contracts available to trade, in contrast, say, to trading

shares of an equity security. The number of futures positions that are open at any time, called open interest, will vary based on trading activity, as market participants trade to establish new positions or to liquidate established positions.

7. Each exchange is responsible for defining the terms and conditions for the futures contracts it lists. Different exchanges may offer competing contracts with very similar (or even copycat) terms, but each exchange's contracts are unique to that exchange, without "cross-market fungibility." In other words, if a person establishes a position in a particular contract listed by an exchange, it may only liquidate that position by establishing an offsetting position in that contract on that exchange and not with another exchange's contract. (Markets participants, though, may establish economically offsetting positions in related contracts, including contracts listed on different exchanges, which may reduce the risk profile of their portfolio of open positions.)

8. As noted, investors trade futures to speculate on changes in the price or value of the commodity and businesses may trade futures for hedging. Some businesses may also use physical delivery futures as a channel to acquire the actual commodity, but that is less common. Market participants typically liquidate their positions in physical delivery futures before incurring final settlement delivery obligations, and typically only a small portion of physical delivery futures contracts result in delivery.

B. **What is an Option? An Option on a Futures Contract?**

1. The term "option" is defined in CEA § 1a(36) as a contract that is "of the character of, or … commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty.'"

2. Under a typical option, the holder, or buyer, pays a premium for the right to require the seller, or the "writer," to sell a commodity or other underlying interest to the option holder at a fixed strike price, in the case of a call option, or to purchase the underlying interest from the option holder at a fixed strike price, in the case of a put option.

3. In either case, the option holder has an "exercise right" to decide whether to require its counterparty to sell the underlying interest to it or buy the underlying interest from it. That right, depending upon the contract terms, may be exercisable at any time through the term of the option (called American style), during a narrowly defined window at the end of the term (called European style) or under other more exotic parameters. The terms of the option may provide for automatic exercise when the strike price is "in-the-money." "In-the-money" means, in the case of a call option, that the strike price is lower than the current market price at which the holder could buy the underlying interest, and, in the case of a put option, that the strike price is higher than the current market price at which it could sell the underlying interest.

4. The underlying interest to an option could be a futures contract (or a swap). Options on futures are exchange-listed contracts, which have standardized terms established by the listing exchange. If a call option is exercised, the option holder buys the underlying futures contract from the option seller (*i.e.*, it establishes a long futures position), and if a put option is exercised, the option holder sells the futures contract to the option seller (*i.e.*, it establishes a short futures position). An exchange may concurrently list options

on a particular futures contract covering multiple futures expiration months and multiple strike prices. The exchange's terms and conditions for the contract will specify if the exercise feature is American style or European style, and will typically provide for automatic exercise of in-the-money options.

C. **What is a "Commodity"?**

1. As noted, futures contracts are "contracts of sale of a ***commodity*** for future delivery." The CEA definition of commodity is much broader than the common understanding of the term, going well beyond physical or tangible commodities. In this regard, CEA § 1a(9) defines "commodity" to cover a list of agricultural commodities and "all other goods and articles … and all services, rights, and interests … in which contracts for future delivery are presently or in the future dealt in." [4]

2. The CEA classifies commodities as (i) agricultural commodities; (ii) "excluded commodities," and (iii) "exempt commodities." As defined in CEA § 1a(19), excluded commodities are generally financial in nature and cover, for example, interest rates, currencies, securities, and other types of financial rates, indices or measures. As defined in CEA § 1a(20), exempt commodities are commodities that are not agricultural commodities or excluded commodities, such as metals or energy commodities. Agricultural commodities and exempt commodities are "nonfinancial" commodities.

3. Examples of commodities under the CEA definition include:

   - Corn, wheat, soybeans, coffee, sugar, lean hogs and other agricultural commodities;
   - Gold, silver, copper or other metals commodities;
   - Natural gas, heating oil, electricity and other energy commodities;
   - Interest rates;
   - Treasury securities;
   - Other types of securities or a group or index of such securities; and
   - Foreign currencies.

[4] There is debate whether the last clause of the definition means that goods or articles, or other services, rights and interests, are commodities for CEA purposes only if they are in fact the subject of futures trading. That is relevant for defining the scope of the CFTC's anti-manipulation authority over cash market activities. Not surprisingly, the CFTC rejects that narrow interpretation. Given the circularity of the definition's last clause, the commodity definition arguably is not much of a limiting definitional element for defining the CEA's scope over futures, but exclusions from the definition do limit the scope of what legally may be traded as futures. The CEA's swap definition also uses the term "commodity," but in sequence with other descriptive terms for permissible underlying interests. Thus, the commodity definition is also relevant for purposes of understanding the broad scope of the swap definition, but is not a limiting definitional element.

4. Congress has excluded onions and movie box office receipts from the term commodity. Consequently (and as intended), it is illegal to trade futures on such commodities. The CEA also prohibits certain types of futures on public policy grounds, such as futures based on terrorist events or that constitute gambling.

VII. Types of Derivatives and Transactions Regulated Under the CEA

A. **Derivatives Classifications**. The CEA and CFTC rules establish different classifications of derivatives, which correspond to differences in regulatory treatment. CEA § 4c gives the CFTC special authority to determine whether to permit trading of options and how to regulate options trading.[5] Consequently, different types of options fall under different classifications for CEA regulatory purposes. The relevant derivatives classifications are:

1. **Futures and Options on Futures**. The CEA and CFTC rules treat futures and options on futures together under the same regulatory regime.

2. **Swaps, Including Commodity Options**. The term "swap" is defined in CEA § 1a(47) and CFTC Rule 1.3. The definition is broad, and covers virtually any type of derivative structure, including traditional swap structures involving the exchange of fixed and floating payments on one or more settlement dates, options on commodities, event contracts, derivatives that are or become commonly known as "swaps," and contracts that are combinations of or options on the foregoing. Except as noted below, the CFTC generally regulates commodity options as swaps.

   The CEA regulatory regime for swaps differs in significant ways from the one for futures and options on futures. For example, the CEA does not mandate that all swaps trading must occur on or subject to the rules of an exchange or that all swaps trades must be cleared.[6] As another example, putting aside swaps executed on an exchange, parties to swaps transactions must have the status of an eligible contract participant ("***ECP***"), as that term is defined in CEA § 1a(18) and CFTC Rule 1.3, for their transactions to be legal. In contrast, they do not need that status to trade futures or options on futures (or swaps) on an exchange.

3. **Commodity Options as Trade Options**. The CFTC decided to exercise its separate regulatory authority over options to exclude certain options from the swaps requirements. Specifically, commercial parties may purchase options on agricultural commodities or exempt commodities from other commercial parties or from ECPs, where the options settle by physical delivery of the commodity, as "trade options" pursuant to CFTC Rule 32.3.

B. **Special Provisions for Regulating "Retail" Transactions Under the CEA**

1. **Retail Forex**. As an exception to the exchange-trading requirement, the CEA contains special provisions in § 2(c)(2)(B) that permit and regulate bilateral OTC trading of foreign

[5] Congress banned trading of options on agricultural commodities (and on agricultural futures) from 1936 to 1983.

[6] The CEA, though, does require that swaps executed on or pursuant to the rules of a DCM must be submitted to clearing.

currency futures and options on futures by retail customers, *i.e.*, by persons that are not ECPs. It also contains comparable provisions in § 2(c)(2)(C) for regulating trading by retail customers of any type of agreement, contract or transaction in foreign currency, regardless whether it could be classified as a futures or a swap, if done on a leveraged, margined or financed basis. The statutory provisions limit the persons permitted to engage in such trading with retail customers, certain of which are persons registered with the CFTC, such as retail foreign exchange dealers.[7] The CFTC Part 5 Rules govern retail forex activities of such persons registered with it.

2. **Retail Commodity Transactions**. CEA § 2(c)(2)(D) provides that agreements, contracts or transactions in commodities (excluding foreign currencies) entered into by or offered to retail customers (non-ECPs) on a leveraged, margined or financed basis are subject to regulatory treatment "as if" they are futures, subject to certain exceptions. One of the exceptions covers transactions that result in "actual delivery" of the commodity within 28 days of the transaction. The CFTC provides interpretive guidance on what constitutes "actual delivery" including guidance specific to crypto-currencies, which exist in digital form. Another exception covers transactions in securities, which makes sense because the SEC regulates cash securities markets.

C. **Catch-All Term—Commodity Interests**. The CEA and various CFTC rules use the term "commodity interest" to refer to the various types of transactions that are subject to regulation under the CFTC (futures, swaps, options regulated under CEA § 4c, retail forex and retail commodity transactions).

D. **Look Beyond the Label**. Derivatives can go by labels that do not appear as defined terms in the CEA, such as "contracts for differences" ("***CFDs***") or "non-deliverable forwards." That does not mean they are unregulated under the CEA. It is important to look beyond the label to the economics of a particular derivative contract, the nature or type of the underlying asset, and how the contract is traded and by whom, to determine if transactions in the contract may be subject to CEA regulation under one of the different regulatory classifications the CEA makes. CFDs, for example, could meet the swap or futures definition, or transactions in CFDs could perhaps be subject to the CEA's provisions for leveraged retail commodity transactions.

VIII. Commercial Forward Contracts and Spot Contracts

A. **Forward Contract Exclusion**. Certain forward contracts are excluded from regulation as futures under the CEA, pursuant to CEA § 2(a), in conjunction with § 1a(27). Section 1a(27) provides that the term "future delivery" used in § 2(a)'s grant of jurisdiction to the CFTC over futures trading does not include "any sale of any cash commodity for deferred

[7] The CEA also provides that FCMs are permissible counterparties that may trade retail forex subject to CFTC regulation. The CEA allocates responsibility to other federal agencies to decide how to regulate retail forex activities of other categories of counterparties, including authority to prohibit those they regulate from engaging in such activities. A firm could fall under multiple recognized counterparty categories. Firms registered with the SEC as broker-dealers may only trade retail forex as permitted and regulated by the SEC. The SEC currently prohibits broker-dealers from trading retail forex, with the effect that firms that are both broker-dealers and FCMs are prohibited from engaging in that activity, even though the CEA and CFTC permit FCMs to trade retail forex.

shipment or delivery." This exclusion has been part of the statute since its inception in 1922. Forward contracts on nonfinancial commodities (and on securities) are also excluded from the CEA's swap definition, and thus from regulation as swaps. Congress used different language to describe the exclusion than it did in the futures context, but when the CFTC adopted swap product definition rules in August 2012, it stated that it interprets the forward contract exclusion from both the futures and swap definitions in a consistent manner.

1. At the risk of oversimplifying, an excluded forward contract is a commercial merchandizing contract for the sale of a nonfinancial commodity (*e.g.*, corn or natural gas) where the parties are commercial in nature, defer delivery for commercial reasons, are capable of making or taking delivery and intend to make or take delivery, and where delivery routinely occurs between them.

2. When the CFTC adopted the swap product definitions, it provided extensive interpretive guidance for determining whether contracts on nonfinancial commodities are excluded forward contracts. Forward contracts may have embedded options or options-like terms, and the interpretation addresses the types of terms that are consistent with the forward contract exclusion, to avoid classification of the contract as an option. The analysis is fact intensive, based on the specific circumstances.

B. **Spot Contracts**. "Spot contracts" are commercial contracts for the sale of a commodity for delivery within two days, or such other short timeframe consistent with applicable cash market convention. The CFTC recognizes that such contracts are generally outside its authority to regulate as futures under the CEA as they lack sufficient "futurity."

C. **Nature of CFTC Oversight**. The CFTC generally does not have authority under the CEA to adopt rules regulating trading in the cash forward or cash spot markets. However, because the futures markets and cash markets are interrelated, the CEA framework does touch cash market activities in certain ways, in terms of CFTC (and exchange) monitoring of cash market activities of users of the futures markets (and swaps markets) and the CFTC's anti-manipulation enforcement authority over cash markets for commodities.

IX. The CFTC

As noted, the CFTC is an independent federal agency, formed in 1975, and is responsible for administering the CEA. The CEA also relies on self-regulation, subject to CFTC oversight. The CFTC's functions and responsibilities over the futures markets include the following:

1. Registration and oversight of exchanges as DCMs or FBOTs.[8]

2. Registration and oversight of clearing houses as DCOs.

3. Registration and oversight of registered futures associations. (There is only one, the NFA.)

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[8] For the swaps markets, the CFTC is responsible for registration and regulation of swap execution facilities and swap data repositories.

4. Registration and oversight of industry professionals.

5. Broad rulemaking authority (but, as noted, generally not over cash market activities).

6. Broad enforcement authority, including anti-fraud and anti-manipulation enforcement authority with respect to both futures and cash market activities.

7. Operation of a customer reparations program.

X. <u>The NFA</u>

NFA is a registered futures association. It is an umbrella SRO for futures industry professionals required to register with the CFTC. (It is also the umbrella SRO for CFTC-registered swap dealers and major swap participants.) As a general matter, the CEA requires registered industry professionals to belong to a registered futures association. (NFA is the only one.) NFA performs a role similar to the Financial Industry Regulatory Authority (known as FINRA) for the SEC-regulated securities markets and SEC-registered broker-dealers, except that NFA does not operate any market facilities.

1. NFA has rules governing industry professionals, and must enforce those rules against its members. It must submit rules and rule changes to the CFTC for review.

2. NFA processes registration applications for industry professionals (in tandem with the NFA membership process) for the CFTC pursuant to delegated authority.

3. NFA receives exemption notices under the CFTC Part 4 Rules governing commodity pool operators and commodity trading advisors, pursuant to delegated authority.

4. NFA offers an arbitration program for handling certain types of disputes between members and their customers.

5. NFA may act as a regulatory services provider to other SROs.

6. NFA is subject to periodic review of its compliance programs by the CFTC.

XI. <u>Futures Exchanges</u>

A. **<u>General</u>**. Exchanges provide centralized auction markets for the contracts they list, on which trading typically occurs anonymously. Exchanges also have self-regulatory responsibilities as SROs. Electronic trading is the most prevalent form of centralized trading today, where orders are sent electronically to and interact on automated trade matching platforms, such as the Globex platform used by the exchanges that are part of the CME Group, but some floor-based “open-outcry” markets (which dominated in olden days) also exist. An exchange may permit certain types of trades to occur away from the centralized market, pursuant to its rules.

B. **<u>DCMs</u>**. U.S. futures exchanges must register with the CFTC as a DCM. The CEA does not provide a standalone definition of the term “designated contract market.” A DCM is a type

of exchange or board of trade that offers a centralized auction market for trading of the contracts that it lists where the trading interest of multiple parties interacts.

1. DCMs are subject to extensive regulation. A DCM must meet core principles and other requirements set out in CEA § 5, and is subject to various CFTC rules, including the Part 38 Rules, which prescribe more detailed obligations around complying with the statutory core principles, and oversight by the CFTC. The core principles include an obligation to provide centralized markets that are "competitive, open, and efficient" and, relating to a DCM's self-regulatory responsibilities, obligations to have market surveillance and enforcement programs and to offer arbitration programs for certain disputes relating to trading in the DCM's markets. A DCM must submit its rules and rule changes to the CFTC, in accordance with CFTC rules, which include provisions that allow a DCM to submit rules with a certification that they comply with applicable CEA and CFTC requirements.

2. As of the date of this paper, 16 exchanges have active DCM registrations. Examples of DCMs include the Chicago Mercantile Exchange, Chicago Board of Trade, New York Mercantile Exchange and Commodity Exchange (subsidiaries of the CME Group) and ICE Futures U.S. (a subsidiary of Intercontinental Exchange Inc.).

C. **FBOTs**. An FBOT is a futures exchange that is located outside the U.S. If an FBOT provides "direct access" to persons located in the U.S., it must register with the CFTC as an FBOT and will be subject to various requirements under the CFTC's Part 48 Rules. "Direct access" means the exchange explicitly grants authority to persons in the U.S. to enter trades directly into the FBOT's matching system. Persons may trade futures or options on futures on an FBOT that is not registered with the CFTC, just not via "direct access." As of the date of this paper, there are 25 FBOTs registered with the CFTC, including ICE Futures Europe, the London Metal Exchange and Eurex.

XII. Clearing Houses

A. What is Clearing?

1. In general terms, clearing is the process by which trades in futures and options on futures (or swaps) are processed, guaranteed and settled by a clearing house. Under a bilateral, non-cleared transaction, each party faces the risk that its counterparty may be unwilling to meet its future payment (or delivery) obligations if it has losses on the position or is unable to perform because its financial circumstances have changed. A party may address the risk of a counterparty's default through various means of credit support, such as collecting collateral from its counterparty or periodically exchanging payments covering changes in market exposure, or obtaining a guarantee from the counterparty's parent. Those credit support terms are subject to negotiation between the parties and are not necessarily reciprocal.

2. Clearing replaces the credit support mechanisms negotiated under bilateral transactions with other mechanisms for managing counterparty default risk. When a transaction is submitted to clearing, the original trade is extinguished and the clearing house becomes the counterparty on two replacement "back-to-back" trades through a process known as novation. By becoming inter-positioned on the trades, the clearing house is able to

manage the default risk on a centralized basis, as a neutral third party. The clearing house manages that risk through various mechanisms, including the daily collection of margin from clearing members and daily settlement of mark-to-market gains and losses with clearing members, and required contributions by clearing members to a guarantee fund.

3. Market participants trading on a particular exchange must use the clearing house that the exchange designates. Parties typically access the clearing house through an FCM, which may be a clearing member of the clearing house or may act through another FCM that is a clearing member.[9] Regardless whether the FCM provides direct or indirect access to clearing, the FCM acts as agent on behalf of its customers, and guarantees its customers' performance of their obligations to the clearing house or to the clearing FCM it uses. Although the clearing house may technically become counterparty to the customer on a novated trade, the clearing house typically deals only with clearing members and not directly with the underlying customers.

4. When a clearing house accepts a trade for clearing, *i.e.*, at the point in time when the trade is novated, the clearing house guarantees the financial performance on the trade to its clearing members. The guarantee is not unlimited. Under certain extreme circumstances, it is possible that a loss caused by the default of a clearing member could be so large that it will have to be shared ("mutualized") across the non-defaulting clearing members. Also, the clearing house guarantee does ***not*** extend to the customers of a defaulting FCM clearing member. The purpose of the guarantee is to protect non-defaulting clearing members, and, in turn, the customers of non-defaulting FCM clearing members, against losses that may result due to another clearing member's default.

5. Given FCMs' integral role in the clearing process and their guarantee of their customers' performance, exchanges or their clearing houses impose requirements on FCMs to collect margin from their customers, often expressed as an initial margin requirement and a lower maintenance margin requirement. The FCM is required to collect the initial margin amount but only has to make a margin call to restore initial margin when adjustments for mark-to-market losses on positions bring the account value below the maintenance margin level. The maintenance margin levels generally equal the amount of initial margin the clearing house would require an FCM clearing member to post to it for the positions. FCMs typically require customers to deposit more margin with them than the minimum amount they are required to collect.

6. The clearing house typically has a role in matching buyers and sellers under physical-delivery futures contracts, as described above. It may also have a role in effecting or facilitating the delivery between the buyer and seller and may require posting of delivery margin. A clearing house may provide a guarantee of performance of the delivery obligation between the buyer and seller; that will vary contract to contract.

B. **Registration and Regulation of DCOs**. A clearing house must be registered with the CFTC as a DCO to clear transactions in futures or options on futures listed on a DCM. (A clearing

[9] When the customer's FCM is not a clearing member, there could be more than one layer of non-clearing FCMs between the customer and the FCM clearing member, if its FCM in turn uses another non-clearing FCM, etc.

house for swaps must also register as a DCO to clear transactions in swaps for U.S. persons, absent an exemption.)

1. As defined in CEA § 1a(15), a DCO is a clearing house or similar facility that performs any of the following functions with respect to contracts, agreements or transactions: (i) it enables the counterparties to the transactions to substitute the DCO's credit for their credit through novation or otherwise; (ii) it arranges or provides for settlement or netting of obligations, on a multilateral basis, resulting from transactions executed by participants in the DCO; or (iii) it otherwise provides clearing services or arrangements that mutualize or transfer the credit risk arising from transactions among the participants in the DCO.

2. DCOs are subject to extensive regulation. A DCO must meet core principles set out in CEA § 5b and other requirements set out in the CEA, and is subject to various CFTC rules, including the Part 39 Rules, which prescribe more detailed obligations around complying with the statutory core principles, and oversight by the CFTC. If the Federal Stability Oversight Council designates a DCO as systemically important, the DCO is subject to heightened requirements under CFTC rules, and is subject to certain oversight by the Federal Reserve Bank. (A non-designated DCO may voluntarily opt-in to the heightened CFTC requirements.) A DCO must submit its rules and rule changes to the CFTC, in accordance with CFTC rules, which include provisions that allow a DCO to submit rules with a certification that they comply with applicable CEA and CFTC requirements.

C. **Registration Not Required for an FBOT's Clearing House**. The clearing house designated by an FBOT to clear trades in futures and options on futures listed on the FBOT does not have to register with the CFTC as a DCO to clear trades for market participants located in the U.S. However, if the FBOT is registered with the CFTC, it has to demonstrate to the CFTC that its clearing house is subject to comprehensive regulation in its home jurisdiction and meets international standards for derivatives clearing.

XIII. Futures Industry Professionals

A. **General Registration Categories**. The CEA imposes registration requirements on certain categories of professionals providing services with respect to the categories of derivatives or transactions regulated under the CEA framework. The relevant registration categories with respect to futures are (i) FCM (futures commission merchant), (ii) introducing broker ("***IB***"), (iii) commodity trading advisor ("***CTA***") and (iv) commodity pool operator ("***CPO***"). Those categories are also relevant with respect to swaps, along with registration categories for swap dealers and major swap participants.[10]

B. **Registration or Fitness Screening of Individuals: APs and Principals**. Individuals who solicit futures customers or supervise such solicitation activities (directly or indirectly) on behalf of a CFTC-registered firm must themselves register with the CFTC as associated persons ("***APs***").[11] Certain individuals may also be classified as "principals" of the firm, including

[10] The CEA and CFTC rules also establish registration categories for retail foreign exchange dealers, retail forex IBs, retail forex CTAs and retail forex CPOs.

[11] This requirement does not apply to the APs of a registered swap dealer or major swap participant.

individuals who hold certain management positions or who directly or indirectly own 10% or more of any class of the firm's voting securities. Individuals who are principals are not required to register with the CFTC or join NFA, but the firm must identify them to the CFTC and NFA and they are subject to fitness screening.

C. **NFA Membership**. With limited exception, a firm or individual that is required to register with the CFTC must become a member of NFA (called an associate member by NFA in the case of an AP). NFA members are subject to NFA's rules, which require compliance with various CFTC rules as NFA rule obligations and impose other obligations. NFA may discipline a member if the member violates an NFA rule.

D. **FCMs**. As defined in CEA § 1a(28) and CFTC Rule 1.3, an FCM is a person that is: (i) "engaged in soliciting or accepting orders for" certain enumerated types of derivatives, including futures (and swaps); and (ii) which, in connection with those activities, accepts any money, securities or property from, or extends credit in lieu thereof to, customers, to margin, guarantee or secure the resulting trades.

   Registered FCMs are heavily regulated, because they provide customers with access to the exchanges and clearing houses and, as clearing intermediaries, they receive and hold funds from their customers. FCMs are subject to a broad range of regulatory requirements, including:

   1. Minimum adjusted net capital requirements;

   2. Treatment, segregated holding of and protection of customer funds (including obligations to contribute their own funds into the pools of customer segregated funds);

   3. Risk management; and

   4. Sales practices.

E. **IBs**. As defined in CEA § 1a(31) and CFTC Rule 1.3, an IB is a person that is: (i) "engaged in soliciting or accepting orders for" certain types of derivatives including futures (and swaps); but (ii) which does ***not***, in connection with those activities, accept any money, securities or property, or extend credit in lieu thereof, to margin, guarantee or secure resulting trades in such contracts. IBs are subject to minimum capital requirements and sales and trading practice requirements, but because they do not hold customer funds, they are not subject to customer funds segregation requirements.

F. **CTAs**. As defined in CEA § 1a(12) and CFTC Rule 1.3, a CTA is a person that, for compensation or profit, is engaged in the business of advising others on the value or advisability of trading in futures, swaps and other CFTC-regulated derivatives, *i.e.*, in "commodity interests." The primary requirements applicable to a registered CTA are set out in the CFTC Part 4 Rules. The CFTC provides certain exemptions from registration to persons covered by the CTA definition, set out in the Part 4 Rules.

G. **CPOs**. As defined in CEA § 1a(11) and CFTC Rule 1.3, a CPO is a person that is engaged in a business in the nature of a commodity pool or an investment trust, syndicate or other form of pooled investment vehicle that invests in futures, swaps or other commodity interests or

in other pooled investment vehicles that invest in such products, and which, in connection with such business, solicits, accepts or receives funds from others through capital contributions, the sale of stock or other securities or otherwise. As a threshold matter, for a person to be a CPO, there must be a commodity pool. Tracking language in the CPO definition, the CEA definition of "commodity pool" in § 1a(10), which was added in 2010, provides that a commodity pool is "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests." The primary requirements applicable to a registered CPO are set out in the CFTC Part 4 Rules. The CFTC provides certain exemptions from registration to persons covered by the CPO definition, and certain exclusions from the CPO and commodity pool definitions, set out in the Part 4 Rules.

H. **Routine SRO Oversight of FCMs**.

1. **The Joint Audit Committee**. The Joint Audit Committee ("***JAC***") is comprised of representatives of the Audit and Financial Surveillance Departments of the NFA and the DCMs. The JAC develops the audit programs that the NFA and exchanges follow when conducting financial or other audits of their FCM members. The CFTC oversees the audit programs developed by the JAC.

2. **The Designated SRO**. Many FCMs belong to multiple DCMs as well as to NFA. The JAC assigns each FCM to a lead SRO, called its designated self-regulatory organization ("***DSRO***"). NFA is the DSRO for any FCM that does not belong to a DCM. For other FCMs, its DSRO will be one of the exchanges where it is a member. The DSRO is responsible for conducting examinations of the FCMs assigned to it with respect to customer protection and financial compliance, in accordance with the audit programs developed by the JAC.

XIV. Accessing the Futures Markets

A. **Accessing a DCM's Markets**. Market participants typically must have arrangements with an FCM to access a DCM's markets and the DCO that clears trades in the DCM's listed contracts. This involves establishing a futures trading account with an FCM. Some market participants, though, clear their trades directly, without using an FCM as a clearing intermediary, by becoming clearing members of the relevant DCO (or DCOs). Although exchanges have members, it is generally not necessary to receive an exchange's approval as a member to trade on the exchange's market. Market participants, though, may have to meet technical, operational or other standards imposed by the exchange or their FCM for sending orders electronically to the exchange's automated matching platform, in particular if a market participant is a high frequency trading firm that generates orders automatically using computer algorithms. Some market participants may also find it advantageous to become a member of an exchange, for example to reduce the transaction fee charges imposed by the exchange or to participate in a market maker or incentive fee program offered by the exchange.[12]

[12] The exchange membership concept is more relevant with respect to floor based trading, where membership confers the privilege of physically accessing the trading floor to trade for one's own account as a floor trader or to fill customer orders as a floor broker.

B. **Accessing an FBOT's Markets**. Market participants located in the U.S. that wish to trade futures or options on futures offered on an FBOT also typically access those exchanges and their clearing houses through an FCM. Alternatively, they could establish futures accounts with a foreign broker that is exempt from FCM registration pursuant to the CFTC Part 30 Rules, on the basis that the foreign broker is subject to regulation in its home jurisdiction that is comparable to and as comprehensive as the regulation that applies to an FCM under the CEA and CFTC rules. Depending on the rules of the FBOT, a person may need the exchange's approval if it sends orders directly to the exchange's matching platform.

C. **Opening a Futures Account with an FCM**. FCMs guarantee financial performance by their customers on their futures positions (and cleared swaps positions) to the relevant clearing houses and/or clearing FCMs (or other clearing brokers, in the case of foreign futures). Thus, not surprisingly, the futures customer agreements appear to be one-sided in favor of the FCM, with provisions that protect the FCM against the risk of the customer's default. The customer's protections derive principally from the stringent regulatory requirements that apply to FCMs, including with respect to protecting customer funds that FCMs hold.

1. The futures account opening documentation with an FCM will typically include (among other items):

    - A customer application form, used to collect information the FCM needs for its regulatory compliance and reporting.
    - A futures account agreement.[13]
    - Risk disclosures.
    - Designation of hedge accounts.
    - Pre-dispute arbitration agreement (optional).

2. The terms of the futures account agreements vary across FCMs, but they typical cover the following items:

    - The FCM's role as one of acting as the customer's agent.
    - Applicable law, with provisions specifying that relevant rules of the CFTC, exchanges, clearing houses, etc., apply to the customer's transactions and the account.
    - The customer's responsibility to post margin and cover trading losses. (Often covered under overlapping provisions, including indemnification.)
    - Events constituting default by the customer (which can include defaults by the customer or its affiliates under other agreements with the FCM or its affiliates) and the FCM's remedies.
    - The customer's pledge of a security interest in collateral held by the FCM (or by an affiliate of the FCM) and how the FCM may apply the collateral in a default.

[13] If the customer will also clear swaps through the FCM, special terms for swaps clearing are typically set out in a cleared derivatives addendum to the futures agreement, which FIA and ISDA developed.

- The FCM's right to impose higher margin requirements than required under applicable law and to impose position limits (as a credit control mechanism).
- Termination of the agreement and the customer's obligation to terminate or transfer open positions under "no-fault" termination.

XV. How the CEA Regulatory Framework Can Apply to Non-Registrant Market Participants

A. Trade Practices

1. Exchanges are required to provide competitive auction markets and have rules that govern trade practices and prohibit manipulative conduct. The CEA directly prohibits certain trading and manipulative conduct, and the CFTC has rules prohibiting certain disruptive or manipulative trading practices. Prohibited activity includes pre-arranged trading, wash trading, spoofing, disrupting the close of trading, manipulation or attempted manipulation.

2. However, exchanges may adopt rules that provide exceptions to the prohibition against pre-arranged trading. Such trading, when permitted, must occur in accordance with the exchanges rules. Common exceptions include:

   - Block trades executed bilaterally off-exchange.
   - Futures or options on futures executed off-exchange as one component (leg) of a packaged transaction called an exchange for a related position.
   - Office transfers (also called transfer trades) of positions between accounts for distinct legal entities with the same beneficial ownership.
   - Pre-negotiated cross-trades sent for execution to the exchange's centralized market, where one side is displayed to the central market for a prescribed time to give others an opportunity to trade against the order before it may be crossed with the other order.

3. A DCM can discipline a market participant for violating trade practice requirements, even if the person is not a member of that market. (As noted, exchanges generally deem persons that trade on their markets to have consented to their jurisdiction.)

4. A person could be subject to civil enforcement action by the CFTC for trade practice violations, even if the DCM has disciplined the person for the same conduct. As an additional layer, a person could be subject to criminal prosecution by the Department of Justice for egregious violations.

B. Position Limits and Position Accountability

1. The CFTC Part 150 Rules govern the CEA position limits framework. The CFTC adopted amendments to the rules, which took effect on March 15, 2021. The changes are significant, including imposing CFTC position limits on certain swaps. The CFTC has established compliance dates to implement the changes on a staggered basis. Thus, things are in a state of flux.

2. The CFTC and exchanges both impose position limits on futures and options on futures. Position limits cap the size of the position that a person may hold or control, absent a hedge exemption or other exemption. Position limits can apply separately to a person's position in the spot month contract, in any single month contract other than the spot month, or in all contract months combined. The exchange will define the specific trading date after which spot month position limits take effect; that date can vary contract to contract, in some cases starting before the first calendar day of the delivery month or in other cases after that date.

3. Position limits apply with respect to positions that a person owns or controls. Under CFTC aggregation standards, a person must count positions the CFTC deems it to own indirectly by virtue of owning (directly or indirectly) 10% or more of a trading entity, unless disaggregation relief is available. The amendments did not change the aggregation standards or exemptions from aggregation.

4. Before the amendments, the CFTC imposed position limits on nine agricultural futures, which also apply to options on the futures. Under the amendments, it expanded the list to add 16 futures contracts on agricultural, energy and metals commodities. The 25 contracts are "core referenced futures contracts." The CFTC limits apply to options on core referenced futures contracts and, as a significant change, will also apply to futures linked to a core referenced futures contract, options on the linked futures, and economically equivalent swaps. Such contracts, along with the core referenced futures and options thereon, are "referenced contracts."

5. The 25 core referenced futures contracts:

   - Nine legacy agricultural futures: CBOT Corn, CBOT Oats, CBOT Soybeans, CBOT Soybean Meal, CBOT Soybean Oil, CBOT Wheat, CBOT Hard Winter Wheat (KW), ISFUS Cotton No. 2, and MGX Hard Spring Wheat (MWE).
   - Seven added agricultural futures: CBOT Rough Rice, CME Live Cattle, ISFUS Cocoa, ISFUS Coffee, ISFUS FCOJ-A, ISFUS Coffee Sugar No. 11 and ISFUS Sugar No. 16.
   - Four added energy futures: NYMEX Light Sweet Crude Oil, NYMEX NY Harbor ULSD, NYMEX RGBOB Gasoline and NYMEX Henry Hub Natural Gas.
   - Five added metal futures: COMEX Gold, COMEX Silver, COMEX Copper, NYMEX Palladium and NYMEX Platinum.

6. Exchanges must impose their own limits on any contracts they list that are subject to CFTC limits, and those limits can be no higher than the CFTC's (but could be lower). For other contracts they list, exchanges may impose position limits or accountability levels in lieu of positions limits, or neither, or a combination of limits, accountability and/or neither for a particular contract. For example, the exchange may impose a limit for the spot month and an accountability level for all months combined. If a market participant holds positions above an accountability level, the exchange may ask the person to explain its reasons for being in the market and may limit the size of the position the person may hold. These general standards will continue to apply to the exchanges under the amendments.

7. The CFTC imposes spot month, single non-spot month and all months combined limits on the nine legacy agricultural futures. In contrast, the CFTC is imposing spot month limits only with respect to the new core referenced futures contracts and their related referenced contracts.

8. The CFTC is applying its limits to a person's aggregate positions in a linked group of referenced contracts across exchanges and in any economically equivalent swaps, with the exception of cash-settled natural gas. This cross-exchange/OTC aggregate approach is a significant change. The CFTC spot month limits, though, apply separately to physical-delivery referenced contracts and cash-settled referenced contracts.

9. For cash-settled natural gas referenced contracts, the CFTC spot month limit will apply per exchange plus a separate limit for economically equivalent swaps. Under a conditional exemption, a person may exceed the CFTC's per exchange/OTC (swap) spot month limit for cash-settled natural gas referenced contracts if, among other limitations, the person holding or controlling the positions does not also hold or control spot month positions in a natural gas physical-delivery referenced contract.

10. Hedge or other exemptions may be available from CFTC or exchange position limits. For contracts subject to both CFTC and exchange limits, a person has to qualify for the exemption with both the CFTC and the exchange. The amendments provide a new definition of bona fide hedging and set out new procedures for obtaining hedge exemptions (including potential CFTC reliance on the exchanges' procedures) that will apply in the future. For contracts subject to CFTC limits, the CFTC is eliminating risk management exemptions granted under current exchange rules.

11. Market participants must comply with CFTC limits for the 16 new core referenced futures and related referenced contracts that are futures and options on futures by no later than **January 1, 2022**. The limits will apply to positions established before this compliance date and which are open as of that date. Market participants must comply with CFTC limits with respect to economically equivalent swaps by no later than **January 1, 2023**. The limits will apply to pre-existing swap positions established after the March 15, 2021 effective date and which are open as of the compliance date. Market participants with positions established under a previously granted risk-management exemption must comply with CFTC and exchange limits **by January 1, 2023**.

C. **Large Trader Reporting**

1. The CFTC has a multi-layered program for collecting large trader information with respect to trading activity in futures and options on futures, set out in Parts 15 through 18 of its rules. The rules impose reporting obligations on FCMs, clearing members and foreign brokers, and on market participants that hold large positions or engage in a high daily volume of trading as defined by the CFTC. The CFTC relies on the information collected to identify accounts under common ownership or control whose positions it will aggregate for market surveillance purposes and for position limits purposes.

2. The CFTC adopted "ownership and control" ("***OCR***") amendments to the rules in 2013 to require FCMs to obtain more detailed information from their customers that the FCMs report to the CFTC, and to collect and report updates to that information. The CFTC and

FCMs expect futures market participants to provide their FCMs with certain account-related information, and to inform their FCMs when the information changes, so that FCMs may meet their OCR reporting obligations.

3. A futures market participant whose open positions or daily trading volume exceeds CFTC-prescribed thresholds is required upon request of the CFTC (referred to as "special call") to complete and file a CFTC Form 40 large trader report. In November 2016, the CFTC started using a new version of the form, which a market participant completes and files electronically. The form instructions provide that a market participant has an affirmative obligation to notify the CFTC of changes to the information provided, but the CFTC currently provides no-action relief from that requirement under CFTC Letter 20-30, subject to the condition that the trader provides its FCM with updates to the information the FCM collects. The no-action relief expires on September 29, 2023.

4. The CFTC adopted Part 20 Rules in 2011, which impose a large trader reporting framework with respect to certain physical commodity swaps. The Part 20 rules apply with respect to a person's positions in nonfinancial commodity swaps that are linked to one of 46 nonfinancial commodity futures contracts listed in Rule 20.2.[14] The CFTC's OCR amendments in 2013 also expanded the large trader framework to cover large volume traders of swaps with respect to their trading on a swap execution facility ("***SEF***") or an exchange. A swaps market participant that is a large trader under Part 20 or a large volume swaps trader under OCR is required upon request of the CFTC to complete and file a CFTC Form 40 large trader report. This is the same form the CFTC uses for futures large trader reporting.

D. **<u>Recordkeeping</u>**

1. CFTC Rules 1.35(a) and 18.05 impose obligations on market participants to maintain certain books and records if they are, respectively, members of a DCM or a SEF, or if their open positions (futures only) or daily trading volume (futures or swaps) exceeds the CFTC-prescribed thresholds that trigger Form 40 large trader reporting obligations. A person that enters into transactions in physical commodity swaps covered by Part 20 could also have recordkeeping obligations under CFTC Rule 20.6, with respect to its activity in such covered swaps.[15] The records must be kept in the manner prescribed in CFTC Rule 1.31.

2. As a general matter, persons required to keep records must keep them for five years, or, for swaps or related commercial forwards, through the expiration or termination of the transaction plus five years. A person must produce the records to the CFTC upon request, and make them available to inspection by representatives of the CFTC or Department of Justice.

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[14] A person is a large trader under Part 20 if it has a position in paired swaps on the same commodity that is equal to or greater than a gross all-months-combined futures equivalent position of 50 contracts. The test applies separately to swaps that are not options and to swaps that are options, referred to under the rules as "swaptions."

[15] A counterparty to swaps also has recordkeeping obligations under CFTC Rule 45.2 solely by virtue of being a party to a swap transaction.

E. **Anti-Manipulation**. The CEA makes it unlawful to manipulate or to attempt to manipulate the prices of any commodity, and vests the CFTC with authority to take enforcement action against any person that engages in such conduct. The CEA also classifies manipulation and attempted manipulation as a criminal felony subject to prosecution by the Department of Justice.

F. **If a Market Participant's FCM Becomes Insolvent**

1. General speaking, if an FCM becomes insolvent, it will become subject to a bankruptcy liquidation proceeding as a "commodity broker" under subchapter IV of chapter 7 of the U.S. Bankruptcy Code, in conjunction with special CFTC Part 190 Rules (which the CFTC recently amended[16]) governing the liquidation of an FCM (or a DCO) under subchapter IV. If the FCM is also registered as a broker-dealer with the SEC (as most are), the proceeding will be initiated by the Securities Investor Protection Corporation under the Securities Investor Protection Act, but the trustee must follow subchapter IV and Part 190 for liquidating the FCM business. It is also possible (but unlikely under current federal policies) that the FCM could instead be liquidated by the Federal Deposit Insurance Corporation ("***FDIC***") in an orderly liquidation proceeding under Title II of Dodd-Frank. The FDIC must distribute customer property consistent with subchapter IV (and by extension, Part 190).

2. In a subchapter IV proceeding, as provided in the Part 190 Rules, the trustee must use its best efforts to transfer customers' positions and account equity to one or more (solvent) FCMs. In addition, the trustee will distribute customer property to the debtor FCM's customers by "account class," *i.e.*, separately for their futures, foreign futures, cleared swaps and delivery accounts, giving priority to public customers of the FCM over non-public customers (such as affiliates or other insiders of the FCM). If the customer property available to distribute in an account class is insufficient to cover the claims of public customers in that account class in full, the trustee will distribute the property to them on a pro rata basis.

XVI. Futures vs. Swaps

A. **Differentiating Between Futures and Swaps**

1. One element of the CEA swap definition covers a traditional swap structure whereby parties agree to exchange one or more payments in the future where one party has a fixed payment obligation and the other has a floating payment obligation linked to changes to a referenced rate, commodity or other benchmark. For example, parties may exchange payments of 3% interest for payments of interest pegged to a fluctuating interest rate, with the interest in each case calculated on a notional principal amount of $100 Million. In lieu of exchanging two full payments, the parties typically net the obligations into a single payment made by the party with the larger payment obligation.

2. This element of the swap definition describes the typical economic structure or terms of a futures contract. However, the CEA also expressly excludes futures (and options on

[16] *Bankruptcy Regulations*, 86 FR 19324 (Ap. 13, 2021).

futures) from the swap definition. Thus, a particular contract must be one or the other and cannot be both a futures contract (or option on a futures contract) and a swap. The CFTC has not adopted any rules or guidance for differentiating between futures and swaps based on their economic terms, but many view futures as having a much higher degree of standardization than swaps to facilitate centralized trading on exchanges. Nonetheless, some instruments classified as swaps could have identical or substantially similar economic terms to instruments classified as futures. Indeed, certain CEA provisions and CFTC rules (notably with respect to position limits) recognize that futures and swaps could be economically equivalent to one another.

3. If a derivative falls in the definitional overlap based on its economic terms, of practical necessity, how parties trade the instrument becomes a factor for deciding how to classify it. In light of the exchange-trading requirement for futures and options on futures, if the instrument is traded other than on or pursuant to the rules of an exchange, the marketplace generally considers the instrument to be a swap, subject to the CEA's swaps regulatory requirements.

B. **High Level Comparison of How Futures are Regulated Compared to Swaps Under the CEA Framework**

Futures	Swaps
Must be executed on an exchange. No cross-market "fungibility."	Multiple trading venues may be available, and the same swap may trade in multiple venues.
Trades must be submitted to centralized clearing; must use the clearing house required by the exchange. Clearing replaces credit support terms in bilateral transactions.	Clearing required only for certain swaps, with exceptions. Whether clearing because required or voluntarily, parties may choose the clearing house.* Parties to non-cleared trades define the credit support terms. * However, if the swap is executed on or subject to the rules of a U.S. futures exchange, it must be cleared and the parties must use the clearing house designated by the exchange.
No trade by trade reporting to a trade data repository.	Transactions must be reported to a swap data repository.
No registration of dealers.	Dealers for swaps may have to register.
Established framework for dealing with cross-border trading; facilitated because an exchange has an identifiable geographic locus.	Cross-border considerations are more complicated.