Are You a Commodity Pool Operator? And, is it Curable?

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Topics for Presentation

• Definitional changes
  • Commodity Pool, Commodity Pool Operator, Commodity Trading Advisor
• Exclusions from definition of “Commodity Pool” – No-Action Relief
  • Securitizations; Equity REITs
• Exemptions from CPO Registration
• Exemptions from CTA Registration
• Rule 4.5 Exclusion
• Harmonization
Definitional Changes

• Dodd-Frank’s inclusion of swaps as commodity interests means that pooled investment vehicles trading in swaps (and their operators or advisors) must consider whether they may be subject to regulation as a Commodity Pool, a Commodity Pool Operator or a Commodity Trading Advisor
Commodity Pool Definition

- As amended by Dodd-Frank, the Commodity Exchange Act ("CEA") now defines the term “commodity pool” to include any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any—
  - (i) commodity for future delivery, security futures product, or swap;
  - (ii) agreement, contract, or transaction described in section 2(c)(2)(C)(i) of the CEA or section 2(c)(2)(D)(i) of the CEA;
  - (iii) commodity option authorized under section 6c of the CEA; or
  - (iv) leverage transaction authorized under section 23 of the CEA

- In addition, the CFTC, by rule or regulation, may include within, or exclude from, the term “commodity pool” any investment trust, syndicate, or similar form of enterprise if the CFTC determines that the rule or regulation will effectuate the purposes of the CEA
Commodity Pool Operator Definition

- As amended by Dodd-Frank, the CEA now defines the term “commodity pool operator” to include any person:
  - (i) engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests, including any—
    - (I) commodity for future delivery, security futures product, or swap;
    - (II) agreement, contract, or transaction described in section 2(c)(2)(C)(i) of the CEA or section 2(c)(2)(D)(i) of the CEA;
    - (III) commodity option authorized under section 6c of the CEA; or
    - (IV) leverage transaction authorized under section 23 of the CEA; or
  - (ii) who is registered with the CFTC as a commodity pool operator
- In addition, the CFTC has the authority to include within, or exclude from, the CPO definition any person if such inclusion or exclusion will effectuate the purposes of the CEA
Commodity Trading Advisor Definition

• As amended by Dodd-Frank, the CEA now defines the term “commodity trading advisor” to include any person who:
  • (i) for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in—
    • (I) any contract of sale of a commodity for future delivery, security futures product, or swap;
    • (II) any agreement, contract, or transaction described in section 2(c)(2)(C)(i) of the CEA or section 2(c)(2)(D)(i) of the CEA;
    • (III) any commodity option authorized under section 6c of the CEA; or
    • (IV) any leverage transaction authorized under section 23 of the CEA;
  • (ii) for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning any of the activities referred to in clause (i)
  • (iii) is registered with the CFTC as a commodity trading advisor; or
  • (iv) the CFTC, by rule or regulation, may include if the CFTC determines that the rule or regulation will effectuate the purposes of the CEA
Commodity Trading Advisor (cont.)

- The CTA definition specifically excludes the following if the commodity advice is “solely incidental to the conduct of their business or profession”:
  - (i) any bank or trust company or any person acting as an employee thereof;
  - (ii) any news reporter, news columnist, or news editor of the print or electronic media, or any lawyer, accountant, or teacher;
  - (iii) any floor broker or futures commission merchant;
  - (iv) the publisher or producer of any print or electronic data of general and regular dissemination, including its employees;
  - (v) the fiduciary of any defined benefit plan that is subject to the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1001 et seq.);
  - (vi) any contract market or derivatives transaction execution facility; and
  - (vii) such other persons not within the intent of this paragraph as the CFTC may specify by rule, regulation, or order
Why should you avoid CPO status?

• A CPO:
  • Is de facto a “financial entity” and not able to avail itself of the end-user exemption
  • Must register itself, and register its principals and associated persons, as members of the NFA
    • Requires filing of a Form 7-R for the entity, and an 8-R for each AP/principal
    • A principal will be understood to include a director, officer, or anyone with decision-making authority
      • A holder of 10% or more of the equity of the entity also is considered a principal
    • An AP must take a Series 3 exam, required ethics training, and subject itself to fingerprinting and other registration obligations
  • Is subject to ongoing compliance obligations
Compliance obligations of CPO/CTAs

- A CPO will be subject to oversight and examinations by the NFA
- A CPO must be prepared to comply with various initial and ongoing reporting, recordkeeping and other requirements, including:
  - The requirement to appoint a CCO
  - The obligation to file with, and have approved by, the NFA a disclosure document, and comply with regulations relating to information disclosures
- A requirement to maintain compliance policies and procedures to provide for appropriate custody of client assets; secure privacy of client information; comply with anti-money laundering requirements; prevent manipulative or disruptive trading practices, ensure business continuity, maintain accurate records, etc.
- File certain annual and other reports, such as Forms CPO-PQR and CTA-PR
Exclusions from Definition of “Commodity Pool” – No-Action Relief

• The CFTC has issued no-action relief to the effect that certain vehicles that trade in swaps need not be considered as a “commodity pool”

• In no-action letters relating to securitization vehicles (each, an “SV”) and equity real estate investment trusts (each, an “equity REIT”), the CFTC has applied a fact-intensive analysis to determine whether or not an SV or equity REIT constitutes a commodity pool

• A primary inquiry is the extent to which such a vehicle’s entering into swaps actually drives (or could actually drive) the investment returns of investors in the vehicles, as opposed to being used for certain limited permitted uses (e.g. credit enhancement and altering rates or currency flows from underlying assets)
Securitizations – No-Action Relief

• CFTC No-Action Letter 12-14 (October 11, 2012) provides that a securitization vehicle will not constitute a commodity pool if it conforms to the following criteria:
  • the issuer of the asset-backed securities is operated consistent with the conditions set forth in Regulation AB, or Rule 3a-7, whether or not the issuer’s security offerings are in fact regulated pursuant to either regulation;
  • the entity's activities are limited to passively owning or holding a pool of receivables or other financial assets (either fixed or revolving) that by their terms convert to cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to security holders;
  • the entity’s use of derivatives is limited to the uses of derivatives permitted under the terms of Regulation AB, which include credit enhancement and the use of derivatives such as interest rate and currency swap agreements to alter the payment characteristics of the cash flows from the issuing entity;
  • the issuer makes payments to securities holders only from cash flow generated by its pool assets and other permitted rights and assets, and not from or otherwise based upon changes in the value of the entity’s assets; and
  • the issuer is not permitted to acquire additional assets or dispose of assets for the primary purpose of realizing gain or minimizing loss due to changes in market value of the vehicle’s assets.
Securitizations – More No-Action Relief

• CFTC No-Action Letter 12-45 (December 7, 2012) provides further detail with regard to securitization vehicles that may or may not constitute commodity pools:
  • “certain securitization vehicles that do not satisfy the operating or trading limitations contained in Regulation AB or Rule 3a-7 may be properly excluded from the definition of commodity pool, provided that the criterion with respect to the ownership of financial assets continues to be satisfied and the use of swaps is no greater than that contemplated by Regulation AB and Rule 3a-7, and such swaps are not used in any way to create an investment exposure”
  • Examples:
    • A “standard asset-backed commercial paper conduit”
      • Even if not falling within the letter of the 12-14 letter, “an investment in this securitization is not unlike an investment in a traditional securitization that satisfies Regulation AB or Rule 3a-7 in that the investment is essentially in the financial assets in the vehicle and not in the swaps”
    • A CDO using swaps to convert fixed rate assets into floating rate assets and FX swaps to convert a foreign currency into dollars
      • Similarly, such an investment “is not unlike an investment in a traditional securitization that satisfies Regulation AB or Rule 3a-7 in that the investment is essentially in the financial assets in the vehicle and not in the swaps”
    • A covered bond transaction
      • The collateral pool (and any special purpose vehicle) “would not be a commodity pool if it contains no commodity interests other than any swaps which are used only for purposes permitted by Regulation AB, and covered bond holders are only entitled to receive payments of accrued interest and repayment of principal of their covered bonds, without any condition to payment based upon any derivative exposure”
Securitizations (further cont.)

• However, if investors in an SV have exposure to swaps which are used to create investment exposure (e.g., the payment to investors is affected by swaps in a way other than to enhance credit (within reason) or to swap interest rates or currencies, each as permitted by Regulation AB), then the securitization vehicle may be a commodity pool
  • Examples:
    • CDO holding a 5% bucket for synthetic assets consisting of swaps rather than having 100% of its holdings in financial assets
    • Repackaging vehicle that issues credit-linked or equity-linked notes where the repackaging vehicle owns high quality financial assets, but sells credit protection on a broad based index or obtains exposure to a broad based stock index through a swap (SV may be a commodity pool because investors in the SV are obtaining a significant component of their investment upside or downside from the related swaps)
    • Repackaging vehicle that acquires a three-year bond, issues a tranche of notes, and uses swaps to extend investment experience of the bond (and notes) to four years
    • “Commercially unreasonable” use of swaps as credit support in a securitization (e.g., to raise “CCC” rated underlying assets to “AA” rating level, thereby making the swap “a significant aspect of the investment”)

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Legacy Securitizations

• CFTC No-Action Letter 12-45 also contains no-action relief for certain legacy securitization issuers of fixed-income securities
• The relief applies if:
  • the issuer issued fixed income securities before October 12, 2012 that are backed by and structured to be paid from payments on or proceeds received in respect of, and whose creditworthiness primarily depends upon, cash or synthetic assets owned by the issuer;
  • the issuer has not issued and will not issue new securities on or after October 12, 2012; and
  • issuer agrees, upon request, to provide disclosure documents and other information
Equity REITs – No-Action Relief

• CFTC No-Action Letter 12-13 (October 11, 2012) provides no-action relief for equity REITS, whose primary source of income is not derived from mortgage interest or fees (typically they derive income from acquiring and developing their own properties)
• An equity REIT does not constitute a commodity pool if the REIT:
  • primarily derives its income from the ownership and management of real estate and uses derivatives for the limited purpose of mitigating exposure to interest rate or currency fluctuation risk;
  • is operated so as to comply with all of the requirements of a REIT election under the Internal Revenue Code, including the requirements that
    • at least 75 percent of the equity REIT’s annual gross income must be derived from qualifying real estate related sources (the “75 Percent Test”); and
    • at least 95 percent of an equity REIT’s annual gross income must consist of items that would satisfy the 75 Percent Test plus other passive income such as interest and dividends (the “95 Percent Test”); and
  • has identified itself as an equity REIT in its last U.S. income tax return and continues to qualify as such, or, if the REIT has not yet filed its first tax filing with the Internal Revenue Service, the REIT has stated its intention to do so and effectuates its stated intention
Exemptions from CPO Registration

• 4.13(a)(1) – closely held pool – not required to register as CPO if
  • does not receive any form of compensation;
  • operates only one pool at a time;
  • not otherwise required to register with the CFTC; and
  • does not advertise

• 4.13(a)(2) – small pool – not required to register if
  • no pools have more than 15 participants (not including pool’s operator, CTA and certain other related persons); and
  • total gross capital contributions in all pools do not exceed $400,000

• 4.13(a)(3) – de minimis rule
  • exclusion from CPO registration for entities that engage in a de minimis amount of derivatives trading activity
The 4.13(a)(3) Exemption

- Rule 4.13(a)(3) exempts pools with investors that are either non-US persons or that meet an “accredited investor”-like standard provided that the pools trades only a *de minimis* amount of commodity interests, whether or not for bona fide hedging purposes.
- Limitations are similar to those in new Rule 4.5:
  - aggregate initial margin, premiums and required security deposit for commodity positions cannot exceed 5% of the liquidation value of the fund’s portfolio (after taking into account unrealized profits and losses), OR
  - the aggregate net notional value of commodity positions will not exceed 100% of the liquidation value of the fund’s portfolio (after taking into account unrealized profits and losses).
- Commodity positions include commodity options, certain swaps, certain forex transactions and futures (including security futures).
The 4.13(a)(3) Exemption

- Manager required to “look through” any pooled investment vehicles in which the fund invests
  - Look-through affects fund of funds
  - May also affect directly managed fund that invests in a registered or unregistered investment company that itself invests in commodity interests
- February 2012 - CFTC rescinded guidance on how to apply Rule 4.13(a)(3) to a CPO of a “fund of funds”
  - Until CFTC provides revised guidance, a CPO of a fund of funds may continue to rely on Appendix A
  - Addresses various situations
    - Fund of funds that invests in unaffiliated fund with a registered CPO
    - Fund that invests in unaffiliated fund that itself relies on Rule 4.13(a)(3)
    - Fund of fund that invests in an affiliated fund
Rule 4.13(a)(4)

- February 8, 2012 – CFTC rescinds exemption for pools with highly sophisticated investors
  - Eliminated broad exemption from most CPO requirements for funds with investors that meet “qualified purchaser standards” or are non-US persons
  - Old rule did not limit amount of trading in commodity interests
  - Many private funds that relied on this exemption but no longer can
    - Many private fund managers will need to comply with Rule 4.13(a)(3) or register as CPO
Exemptions from CTA Registration

• Section 4.14(a) provides exemptions from registration as a CTA.
• The exemptions include:
  • 4.14(a)(8) – A CTA whose CPO qualifies for the de minimis exemption can be exempt from CTA registration if such CTA (i) is registered (or exempt from registration) as an investment adviser with the SEC, (ii) provides commodity interest trading advice solely incidentally to its business, and (iii) does not hold itself out as a CTA
  • 4.14(a)(10) – A CTA that has no more than 15 clients (with each fund typically counting as one client) during the prior 12 months and does not hold itself out to the public as a CTA. A CTA whose principal place of business is outside of the US need only count clients that are US residents
Relief for Mortgage REITS

• Mortgage REITs use interest rate and currency swaps and other derivatives to hedge the risks associated with the mortgage loans or MBS that they hold;

• In letter 12-44 (December 7, 2012), the CFTC’s DSIO provided limited relief for mREITs that meet certain conditions

• Mortgage REITs may be deemed commodity pools but may indicate to the CFTC that they will satisfy the conditions limiting their use of derivatives and no enforcement action will be taken against them for not registering as CPOs

• This relief is different from the relief granted to equity REITs (which were specifically excluded from being considered CPOs), and as a result, mortgage REITs as non registered CPOs will be deemed “financial entities” in the absence of further relief
Business Development Companies

- BDCs are closed end funds and may use swaps for limited purposes
- CFTC makes clear that it considers BDCs to fit within the CPO definition
- December 4, 2012 – Letter 12-40 – DSIO staff clarified how Rule 4.5 exclusion applies to BDCs
  - Absent relief, BDCs cannot rely on Rule 4.5 exclusion
  - A BDC that enters into even one swap contract can trigger registration requirements
  - No-action letter applies Rule 4.5 standards to BDCs
    - Limit swaps for bona fide hedging
    - Limit volume of activities
Relief for Pension Plan Group Trusts

- In letter 12-72 (December 21, 2012), the CFTC’s DSIO granted relief from CPO and CTA registration with respect to pension plan group trusts.
- The group trust at issue was formed and operated for the purpose of investing assets of participating trusts forming part of certain pension plans.
- Each plan participating in the group trust was excluded from the definition of “pool,” but there existed no similar provision for the group trust itself.
- In accordance with prior practice, the CFTC granted CPO and CTA registration relief with respect to operating or advising the group trust.
Relief for Fund of Fund Operators

• November 29, 2012 – CFTC staff addresses CPO registration requirements of fund of fund operators
  • Fund of funds operators may be required to register if fund of funds has indirect exposure to commodity interests
  • Division of Swap Dealer and Intermediary Oversight (DSIO) staff won’t recommend enforcement action if fund of funds operators that may be required to register as CPOs by December 2012 do not register until staff issues revised guidelines if
    • The CPO currently structures its operations in whole or in part as a CPO of one or more “funds of funds,” and
    • The amount of direct commodity interest trading by the fund of funds does not exceed trading restrictions in Rule 4.5 and 4.13(a)(3) and
    • The CPO does not know and could not reasonably have known that indirect exposure to commodity interests exceeds those restrictions, and
    • The fund of funds is either a registered investment company or complies with Rule 4.13(a)(3)(i)
  • The fund of funds relief is not self-executing
  • No-action relief in effect until the later of June 30, 2013 or six months from the date that CFTC issues revised guidance on application of de minimis thresholds in the context of Rules 4.5 and 4.13(a)(3)
Relief for Sub-Advisors

- In Letter 12-54 (December 12, 2012), the CFTC’s DSIO granted relief from CTA registration with respect to a sub-advisor (“A”) of an advisor (“B”) with respect to investment companies for which “B” was required to be registered as a CPO
- “B,” the advisor, conducted its advisory functions indirectly, through sub-advisors such as “A”
- “B” owned and controlled “A”
- “A” and “B” agreed to joint liability for any violations of the CEA or regulations thereunder
- Letter concluded that “B” was effectively responsible for providing commodity interest trading advice and there would be no recommended action against the sub-advisor, “A,” for its failure to register as a CTA
Relief for Family Offices

• CFTC No-Action Letter 12-37 (November 29, 2012) provides no-action relief for a family office, defined as a professional organization that is wholly-owned by clients in a family and exclusively controlled (directly or indirectly) by members of a family and/or entities controlled by a family
• Previously, family offices had been exempted from registration as CPOs under a CFTC regulation that was rescinded (4.13(a)(4))
• Rationale: need for regulation reduced by participants with close relationships and direct relationship between client and advisor
• Requirement that family offices affirmatively claim this relief in writing
Rule 4.5 Exclusion

- Rule 4.5 excludes from the definition of a CPO “qualifying entities” that operate pools regulated by some other regulatory authority.
- Qualifying entities include:
  - Registered investment companies (that comply with restrictions)
  - Insurance companies with respect to separate account
  - Bank, trust company or financial depository institution with respect to trust or custodial assets while acting in fiduciary capacity
  - Trustee or named fiduciary of, or employer maintaining an ERISA pension plan.
- February 9, 2012 – CFTC amended Rule 4.5 to sharply limit the ability of advisers to registered investment companies that use derivatives to rely on the exclusion.
Rule 4.5 Exclusion

• Reinstatement of “5% threshold”
  • Eliminated in 2003
  • Requires advisers to registered funds that hold certain commodity interests whose aggregate initial margin and premiums that exceed 5% of the liquidation value of the fund’s portfolio to register as CPO
    • Distinguish between derivatives for risk management and bona fide hedging
    • Count derivatives trades used for managing risk toward 5% limit, but exclude “bona fide hedging” transactions
    • OK to exclude options that are in-the-money options at time of purchase

• Alternative net notional test
  • Fund’s aggregate net notional value of the fund’s commodity interest positions may not exceed 100 percent of the liquidation value of the fund’s portfolio (taking into account unrealized profits)
  • Funds can satisfy either test

• Notional value defined for futures and swap positions
Rule 4.5 Exclusion

• Netting
  • Funds may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade
  • Swaps cleared on the same designated clearing organization when appropriate

• Holding out
  • To rely on the exemption, fund must not hold itself out as a vehicle for trading commodity interests

• Annual notice
  • Funds relying on Rule 4.5 must file notice of exclusion and annual affirm the notice
  • Must withdraw exemption if activities no longer would require registration

• Who must register?
  • Advisers to funds that qualify as CPOs but do not otherwise qualify for an exclusion or another exemption from registration must register with CFTC
Rule 4.5 Exclusion

• Why?
  • CFTC expressed concern that certain registered funds were offering interests in de facto commodity pools while claiming exclusion from the definition of CPO pursuant to Rule 4.5
    • CFTC concerned that funds are using managed futures strategies without proper oversight under the guise of being an investment company
    • CFTC “aware of increased trading activity in the derivatives area by such entities that may not be appropriately addressed in the existing regulatory protections, including risk management and recordkeeping and reporting requirements

• Effect of amended rules
  • Increased compliance costs of investment companies and advisers that are required to register with the CFTC
  • Some funds must find alternatives to using covered commodity interests

• Dissent
  • One Commissioner dissented, saying that cost-benefit analysis would not survive judicial scrutiny (she was not correct)
Rule 4.5 Fallout

- April 17, 2012 – ICI and Chamber of Commerce sue CFTC
  - Argue that amended Rule 4.5 imposes unnecessary, overlapping and burdensome regulation on funds, advisers and shareholders
  - Claimed that Rule 4.5 amendments are arbitrary and capricious and that CFTC violated APA
- December 12, 2012 – District Court upholds CFTC’s Rule 4.5 amendments
  - “Nothing arbitrary and capricious about the CFTC’s decision” to amend rules
  - Plaintiffs “have thrown everything in the proverbial kitchen sink at the CFTC” in efforts to stop the rules
- December 27, 2012 – ICI and Chamber file Notice of Appeal
- January 3, 2013 – ICI and Chamber file “Emergency Motion” for expedited consideration of appeal
Harmonization

• The challenge: harmonize duplicative, inconsistent and conflicting disclosure and reporting requirements
  • How do investment advisers to registered funds that do not satisfy Rule 4.5 conditions comply with these inconsistent requirements?
    • Timing and delivery of disclosure documents
    • Signed acknowledgement requirement for receipt of disclosure documents
    • Update cycle
    • Timing of financial reporting
    • Record keeping requirements
    • Required disclosure of fees
    • Required disclosure by CFTC of past performance
    • Mandatory certification language required by CFTC
    • SEC-permitted use of summary prospectus
Harmonization

• Document delivery and acknowledgement
  • CFTC proposal would exempt CPOs from requirement deliver a disclosure document no later than the time the CPO delivers a subscription agreement from obtaining signed acknowledgement provided that CPO
    • Posts Disclosure Document on CPO’s website
    • Updates the Disclosure Document as required
    • Informs prospective participants with whom it has contact of the website address and directs intermediaries selling shares to inform prospective participants
    • Disclosure Document must comply with Part 4 of CFTC rules

• Disclosure Document Updates
  • CFTC proposal would allow CPOs to update Disclosure Document every 12 months, rather than every 9 months
Harmonization

• Performance information
  • CFTC proposal recognizes that CFTC performance reporting requirements may conflict with SEC requirements relating to use of past performance
    • If a fund is a commodity pool in operation for less than three years, CFTC proposes to require disclosure of performance of affiliated pools and accounts in fund SAI
    • Would require SEC and CFTC cautionary statements
    • Seeks public comment on how to handle conflicts

• Break-even point and other fee disclosures
  • CFTC required fee disclosures that are not included in fund fee tables would be disclosed in the fund’s prospectus
    • Also must include tabular presentation of calculation of pool’s break-even point required by CFTC
Harmonization

- Periodic reports to shareholders
  - SEC requires semi-annual reports, while CFTC requires monthly reports to pool participants
  - CFTC would require monthly reports
  - SEC registered funds could post reports on website
- Certifications
  - CFTC harmonization would accept Form N-CSR certification
- Record keeping
  - CFTC harmonization would let CPOs maintain records with pool’s administrator, distributor or custodian
    - CFTC rules require CPO to maintain records solely at its main business office
Bona fide hedging

• Bona fide hedging generally does not include risk management transactions
  • Risk management transactions may present more market risk because they are not
    offset by exposure in physical markets
• October 2012 – DSIO staff clarifies position on bona fide hedging
  • Rule 4.5 excludes positions for “bona fide hedging” from 5% threshold
  • Staff said it will not recommend enforcement action against pools that apply the
    Rule 4.5 trading threshold test that excludes certain transactions that fall within the
    substance of Rules 1.3(z)(1) and 151.5
    • Generally, refers to bona fide hedging transactions include those that represent a
      substitute for transactions or positions to be taken at a later time in a physical
      marketing channel when they are economically appropriate to reduce risks in the
      conduct and management of a commercial enterprise
      • Purpose of transaction must be to offset price risks incidental to commercial cash
        or spot operations and must be established and liquidated in an orderly manner