



DERIVATIVES UPDATE

CFTC Proposes Compliance and Implementation Schedules for Clearing, Trade Execution, Documentation and Margin Requirements under Dodd-Frank and Provides Additional Guidance on Dodd-Frank Implementation Schedule

On September 8, 2011, the Commodity Futures Trading Commission (“CFTC”) held an open meeting at which it approved¹ two notices of proposed rulemaking relating to the implementation timing of the clearing, exchange trading, documentation and margin requirements under the Dodd Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).² The proposed rules are designed to provide additional time for compliance and to facilitate the transition to the new regulatory regime for swaps in a manner that is not unduly disruptive. The proposed rules follow up on a May 2011 CFTC-SEC joint roundtable on implementation timing at which the agencies received input from market participants on the proper timing and order of implementation of their derivatives rules. A theme that emerged from that roundtable was that certain market participants may need more time than others to bring their activities into compliance with the derivatives reforms. The CFTC has reflected that theme by adopting tiered implementation timing regimes under each of the proposed rules.

At the open meeting, the CFTC also distributed an outline of final Dodd-Frank derivatives rules that the CFTC “may” consider during the remainder of 2011 and in the first quarter of 2012. The proposed rules and the outline are discussed in further detail below.

Phased Implementation of Clearing and Trade Execution Mandates

Dodd-Frank added a provision to the Commodity Exchange Act (“CEA”) that makes it unlawful to engage in any swap subject to a CFTC clearing mandate unless the swap is cleared through a derivatives clearing organization (“DCO”).³ Under Dodd-Frank, the CFTC may issue a clearing mandate unilaterally or in response to a request from a

¹ Note that both proposals were passed by the CFTC on votes of 4-1, with Commissioner O’Malia voting against. He also issued vigorous dissents on both proposals.

² Public Law 111-203, 124 Stat. 1376 (2010), *available at* http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/hr4173_enrolledbill.pdf.

³ *See* Dodd-Frank § 723(a)(1), adding CEA § 2(h)(1)(A).

DCO to list a swap for clearing.⁴ A swap that meets the requirements of the “end user exemption” will be exempt from any such clearing mandate, although the end user party may elect to have any swap that would have been subject to a clearing mandate absent an exemption cleared through the DCO of its choice. The CFTC’s September 8, 2011 notice of proposed rulemaking⁵ would give the CFTC discretion to phase in implementation of any clearing mandate for 90, 180 or 270 days,⁶ depending on the types of entities that are party to the relevant swap. The trigger for the implementation phase-in period would be the issuance of a clearing mandate by the CFTC.⁷ Although the CFTC intends to conduct self-initiated reviews on an ongoing basis to determine whether to issue a clearing mandate, it has stated that its initial clearing mandates would only apply to those swaps that a DCO is seeking to clear or that are already cleared by at least one DCO. In the Clearing Proposal, the CFTC also indicated that it intends to begin the clearing mandate review process in the “near term” for interest rate, credit and commodity swaps (*i.e.*, those swaps already cleared by multiple DCOs).

The implementation timeframes under the Clearing Proposal would differ depending on the nature of the parties to the swap, as follows:

- For a swap between a Category 1 Entity and another Category 1 Entity or any other entity that desires to clear the transaction, compliance with the clearing mandate would be required no later than 90 days after the effective date set by the CFTC. Category 1 Entities would include any swap dealer, security-based swap dealer, major swap participant, major security-based swap participant, or “active fund.” The proposal would define an “active fund” as any private fund (*i.e.*, any fund that is excluded from the definition of an “investment company” under the Investment Company Act of 1940, as amended, pursuant to Section 3(c)(1) or 3(c)(7) thereof), that is not a “third-party subaccount”⁸ and that executes 20 or more swaps per month.⁹
- For a swap between a Category 2 Entity and (a) a Category 1 Entity, (b) a Category 2 Entity or (c) any other entity that desires to clear the transaction, compliance with a clearing mandate would be required no later than 180 days after the effective date set by the CFTC. Category 2 Entities would include any commodity pool, private fund other than an active fund, employee benefit plan, or person predominately engaged in activities that are in the business of banking or that are financial in nature, provided that the entity is not a third-party subaccount.
- For all other swaps, compliance with a clearing mandate would be required no later than 270 days after the effective date set by the CFTC.

Swaps that are subject to a clearing mandate but that do not meet the requirements of the end user exemption, will be required to be traded on a designated contract market (“DCM”) or a newly created category of trading facility under

⁴ The CFTC’s rules for reviewing swaps to determine whether to mandate clearing were finalized in July 2011. *See* Process for Review of Swaps for Mandatory Clearing, 76 FR 44464 (July 26, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-07-26/pdf/2011-18663.pdf>.

⁵ Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister090811b.pdf> (the “Clearing Proposal”).

⁶ As proposed, the three compliance periods would only be implemented with respect to a particular clearing mandate in the CFTC’s discretion. The CFTC could elect to disregard the implementation timeframes in the proposal in favor of different timeframes or even immediate effectiveness.

⁷ Note that the CFTC will not issue a clearing mandate with respect to any swap (either unilaterally or in response to a request from a DCO) until a substantial number of other Dodd-Frank regulations are also implemented. Specific rulemakings that must be finalized before any clearing mandate is implemented include the end-user exemption to the clearing and exchange trading requirements, the joint CFTC-SEC product and entity definitions, and rules regarding segregation of customer funds in connection with cleared swaps.

⁸ A “third-party subaccount” would be defined as any “managed account that requires specific approval by the beneficial owner of the account to execute documentation necessary for executing, confirming, margining, or clearing swaps.”

⁹ The 20 swap per month metric would be calculated, for purposes of the Clearing Proposal, as an average over the 12 months preceding the CFTC’s issuance of the relevant clearing mandate.

Dodd-Frank known as a swap execution facility (“SEF”). This exchange trading mandate will not apply to a swap if no DCM or SEF makes that swap available for trading. The Clearing Proposal provides that a swap that is subject to a clearing mandate will also become subject to an exchange trading mandate either (a) on the same timeline described above with respect to clearing mandates or (b) 30 days after the swap is first made available for trading on a DCM or SEF, whichever is later.

Phased Compliance with Documentation and Margining Requirements

Dodd-Frank added new provisions to the CEA providing for the registration and regulation of swap dealers and major swap participants.¹⁰ Among these new provisions were a requirement that the CFTC adopt initial and variation margin levels for uncleared swaps entered into by swap dealers and major swap participants¹¹ and a requirement that the CFTC adopt rules setting documentation standards for swap dealers and major swap participants with respect to the “timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps.”¹² The CFTC has proposed, but not yet adopted, regulations implementing both of these provisions.¹³ On September 8, 2011, the CFTC issued a further notice of proposed rulemaking¹⁴ with respect to margin and documentation requirements that would establish implementation schedules of 90, 180 or 270 days, depending on the types of entities involved.

The implementation timeframes under the Documentation Proposal would differ depending on the nature of the party to the swap, as follows:

- For a swap with a Category 1 Entity, the swap dealer or major swap participant would be required to comply with the CFTC’s margin and documentation requirements, as applicable, no later than 90 days from the date such requirements are published in the Federal Register. Category 1 Entities would be defined in the same manner under the Documentation Proposal as under the Clearing Proposal, except that the time period used for determining whether a private fund is an active fund would be triggered by the publication in the Federal Register of final margin or documentation rules, as applicable, instead of the issuance of a clearing mandate.
- For a swap with a Category 2 Entity, the swap dealer or major swap participant would be required to comply with the CFTC’s margin and documentation requirements, as applicable, no later than 180 days from the date such requirements are published in the Federal Register. Category 2 Entities would be defined in the same manner under the Documentation Proposal as under the Clearing Proposal.
- For a swap with a Category 3 or Category 4 Entity, the swap dealer or major swap participant would be required to comply with the CFTC’s margin and documentation requirements, as applicable, no later than 270 days from the date such requirements are published in the Federal Register. Category 3 Entities would include any Category 2

¹⁰ See Dodd-Frank § 731, adding CEA § 4s.

¹¹ CEA §§ 4s(e)(1)(B), 4s(e)(2)(B)(ii).

¹² CEA § 4s(i).

¹³ See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (April 28, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-04-28/pdf/2011-9598.pdf>; Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715 (February 8, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-02-08/pdf/2011-2643.pdf>. Note that the CFTC’s margin requirements will apply to swap dealers and major swap participants for which there is no prudential regulator (*i.e.*, those entities not regulated by one of the Federal banking regulators), while the CFTC’s documentation requirements will apply to all swap dealers and major swap participants, irrespective of whether such entities are also subject to Federal banking regulation.

¹⁴ Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements under Section 4s of the CEA, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister090811.pdf>. (the “Documentation Proposal”).

Entity whose positions are held as a third-party subaccount, while Category 4 Entities would include any entity not otherwise included in any of Categories 1, 2 or 3.

Outline of Final Dodd-Frank Rulemakings in 2011 and Early 2012

During the open meeting, the CFTC also distributed a one-page document entitled “*Outline of Final Dodd-Frank Title VII Rules the CFTC May Consider in 2011 and the First Quarter of 2012.*”¹⁵ The outline indicated that the CFTC may consider final rules in 2011 on the following topics:

- Clearinghouse rules;
- Data recordkeeping and reporting rules;
- Rules implementing the end-user exception to the clearing and exchange trading mandates;
- Entity definitions (*e.g.*, swap dealer, major swap participant, eligible contract participant)¹⁶ and entity registration rules;
- External business conduct standards;
- Internal business conduct standards (*e.g.*, duties, recordkeeping and chief compliance officer requirements);
- Position limits;
- Product definitions (*e.g.*, swap, security-based swap);¹⁷
- Commodity options;
- Real-time reporting;
- Segregation for cleared swaps; and
- Rules for designated contract markets and foreign boards of trade.

The outline also indicated that the CFTC may consider final rules during the first quarter of 2012 on the following topics:

- Capital and margin requirements (for those swap entities regulated by the CFTC);
- Client clearing documentation and risk management;
- Conforming rules;
- Disruptive trading practices;
- Governance and conflicts of interest;
- Internal business conduct (documentation);
- Investment of customer funds;
- Swap execution facilities;
- Segregation for uncleared swaps; and
- Straight-through trade processing.

¹⁵ Available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/genslerstatement090811c.html>.

¹⁶ Note that the entity definitions must be issued jointly with the Securities and Exchange Commission (“SEC”) and therefore implementation of those rules is not within the sole control of the CFTC.

¹⁷ The product definitions must also be issued jointly with the SEC.

CFTC Chairman Gensler indicated at the open meeting that the outline provided was subject to change and meeting the proposed schedule depends on many factors, some of which are not within the CFTC's control. The dates and order in which the CFTC finalizes its Dodd-Frank rulemaking could differ substantially from those provided in the outline. Note that, notwithstanding the general July 16, 2011 statutory effective date for the derivatives provisions of Dodd-Frank, many of those provisions are currently delayed pursuant to a CFTC order, pending finalization of the Dodd-Frank product and entity definitions.¹⁸

Conclusion

Persons interested in commenting on the Clearing Proposal or the Documentation Proposal must submit their comments within 45 days of the publication of the respective proposal in the Federal Register. Note that as of the date of this Sidley Update, neither proposal has been published for comment.

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¹⁸ Effective Date for Swap Regulation, CFTC Final Order, 76 FR 42508 (July 19, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-07-19/pdf/2011-18248.pdf>; see CFTC and SEC Delay Dodd-Frank OTC Derivatives Reforms, Sidley Derivatives Update, June 20, 2011, available at <http://www.sidley.com/sidleyupdates/Detail.aspx?news=4855>.