



SECURITIES AND FUTURES REGULATORY UPDATE

CFTC Finalizes Significant Dodd-Frank Swap Regulations and Proposes Long-Awaited Regulations Implementing Volcker Rule

On January 11, 2012, the Commodity Futures Trading Commission (“CFTC”) held an open meeting and approved the following rule releases relating to the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”):¹

- Final Rule on Registration of Swap Dealers and Major Swap Participants (77 Fed. Reg. 2613 (January 19, 2012));
- Delegation of Authority Order on Performance of Registration Functions by National Futures Association with Respect to Swap Dealers and Major Swap Participants (77 Fed. Reg. 2708 (January 19, 2012));
- Final Rule on Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties (not yet published in the Federal Register);
- Final Rule on Protection of Cleared Swaps Customer Contracts and Collateral: Conforming Amendments to the Commodity Broker Bankruptcy Provisions (not yet published in the Federal Register); and
- Proposed Rule on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (*i.e.*, the so-called “Volcker Rule”) (not yet published in the Federal Register).

Registration of Swap Dealers and Major Swap Participants

The CFTC’s Final Rule on Registration of Swap Dealers (“SDs”) and Major Swap Participants (“MSPs”)² requires that all SDs and MSPs register with the CFTC by becoming members of a registered futures association, if they are not already members. At present, the National Futures Association (“NFA”) is the only such association, and NFA Form 7-R is the NFA’s form on which SDs and MSPs may register. Form 7-R calls for various types of organizational and business data to be filed, including information substantiating the registrant’s prospective compliance with the CFTC’s implementing regulations under Section 4s of the Commodity Exchange Act. Such regulations include requirements as to capital and margin, recordkeeping and reporting, maintenance of trading records, business conduct, counterparty trading documentation, conflicts of interest, risk management, portfolio reconciliation and compression and similar duties, appointment of a chief compliance officer and segregation of funds provided by customers under uncleared

¹ See http://www.cftc.gov/PressRoom/Events/opaevent_cftcdoddfrank011412.

² Available at: <http://www.cftc.gov/PressRoom/Events/ssLINK/2012-792a>.

swaps. *Applications for registration as an SD or MSP will not be required until the CFTC's final rules defining "swap dealer," "major swap participant" and "swap" have become effective.*³ However, the CFTC included provisions that permit applicants to begin the registration process provisionally, in advance of the effective date of the requirement to register as an SD or MSP, and so market participants that believe they may ultimately be required to register may apply for provisional registration prior to being required to register. Those market participants that believe they will be SDs or MSPs may wish to consider provisional registration, as this will allow a ramp-up compliance period and avoid delay or possible loss of business continuity arising out of a rush of registrations as the registration deadline approaches. Such market participants should consider carefully the implications of subjecting themselves to an as-yet incomplete set of procedural and substantive requirements and the potential adverse effect on their businesses in the event that their registration forms, once filed, are determined by the NFA to be deficient (as a result of failure to demonstrate compliance with a CFTC Section 4s implementing regulation). The effect of a deficiency finding by the NFA regarding an application by a provisionally-registered SD or MSP is that the NFA is required to "notify the applicant that its application is deficient, whereupon the applicant must withdraw its registration application, it must not engage in any new activity as a [SD or MSP] and the applicant shall cease to be provisionally registered".⁴

Delegation of Registration Functions to NFA

The CFTC has delegated authority over registration of SDs and MSPs to the NFA, which as of January 19 began accepting applications for provisional registration.⁵ This delegation by the CFTC is consistent with previous delegations of authority to the NFA, which already acts as the self-regulatory organization of the futures industry.

Counterparty Business Conduct Standards

Dodd-Frank requires the CFTC to set business conduct standards for SDs and MSPs, including special rules applicable when an SD or MSP is dealing with government entities and certain employee benefit plans and endowments. The CFTC's final rule in this regard is meant to prohibit abusive practices and require disclosure of material information to counterparties.⁶ The rule sets forth policies and procedures to ensure compliance and prevent evasion of commodities laws and regulations, recordkeeping requirements, including documenting compliance, and, for SDs, "know your counterparty" rules.⁷ As was true under the CFTC's proposed rule, SDs or MSPs doing business with "special entities" are subject to more stringent substantive and procedural requirements. The CFTC stated that the standards generally have been borrowed from existing industry "best practices," including self-regulatory organization rules and requirements.

Cleared Swap Customer Contract and Collateral Protection

Section 724(a) of Dodd-Frank requires the segregation of cleared swaps and associated collateral for customers. In furtherance of this statutory requirement, the CFTC has adopted the so-called Legally Segregated Operationally

³ As of this writing, the CFTC had scheduled, but subsequently cancelled, a vote on final regulations defining these terms. The CFTC has not yet rescheduled that vote. Final regulations establishing the "entity definitions" and "product definitions" must be issued jointly with the Securities and Exchange Commission. Once issued, the final regulations will likely include a delayed and phased compliance timeframe.

⁴ See 17 C.F.R. Part 3 at §3.10(a)(1)(v)(d)(1). Although two provisos to the Final Rule at this Part may allow provisional registrants some latitude for curative action (to cure a deficiency within 90 days or, on written request submitted to the CFTC, within an extended period granted by the CFTC in its discretion), it is not clear that new activity as an SD or MSP is permissible during the applicable cure period.

⁵ Available at: <http://www.cftc.gov/PressRoom/Events/ssLINK/2012-791a>.

⁶ Available at: <http://www.cftc.gov/PressRoom/Events/ssLINK/federalregister011112e>.

⁷ Not all of the CFTC's business conduct regulations apply equally to SDs and MSPs: the CFTC, in making distinctions in the applicability of the particular requirements, sought to respond to comments that MSPs ought not to be treated as SDs in all respects.

Commingled Model (“LSOC Model”) for cleared swap customer protection.⁸ The LSOC Model requires that cleared swaps and associated customer collateral be segregated from a clearing member’s own property, but allows the customer swaps and collateral to be held in a single account for operational convenience. In a clearing member insolvency, unlike the procedures followed with respect to futures trading, only collateral associated with cleared swaps positions that lost value could be used to meet the losses of such losing positions. Collateral associated with “flat” or in-the-money cleared swaps positions is required to be separated. The goal of the LSOC Model is to ensure that collateral of non-defaulting customers is not used to satisfy the losses of defaulting customers in the event that some or all customer positions are closed out and offset against available customer collateral, and that such collateral is available to transfer to a solvent clearing member in the event of the insolvency of the original clearing member to the degree that cleared swaps customer positions are being so transferred rather than being closed out. The segregation requirements will become effective 60 days after publication in the Federal Register but compliance is deferred until November 8, 2012.

Proposed Rule on Prohibitions and Restrictions on Proprietary Trading

Section 619 of Dodd-Frank sets forth the so-called “Volcker Rule,” which prohibits, subject to exemptions for customer transactions and certain hedging activities, banking entities (as defined) from (1) engaging in proprietary trading in, among other covered financial positions, futures and derivatives transactions, (2) acquiring or retaining any interest in a hedge fund or private equity fund, and (3) sponsoring any hedge fund or private equity fund. Section 619 requires the CFTC, the Securities and Exchange Commission (“SEC”) and the federal banking regulators to adopt implementing regulations. On October 12, 2011, the SEC and the federal banking regulators released highly detailed proposed rules to implement the Volcker Rule.⁹ The CFTC’s proposed rules¹⁰ are substantially similar to those proposed by the other regulatory agencies in October.¹¹

House of Representatives Agriculture Committee Consideration of Swaps Regulation Proposals

In addition to the CFTC rulemaking on January 11, 2012, on January 25, 2012 the House of Representatives Agriculture Committee (the “Agriculture Committee”) met to consider six legislative proposals related to swaps regulation under Dodd-Frank. The Agriculture Committee reported favorably on Cost Benefit Analysis (H.R. 1840), which would require the CFTC to enhance its consideration of costs and benefits with respect to its Dodd-Frank related rulemaking. The Agriculture Committee also reported favorably on a variety of bills that would seek to exempt certain end-users from the regulations imposed by or under Dodd-Frank: the Business Risk Mitigation and Price Stabilization Act of 2011 (H.R. 2682), the Small Business Credit Availability Act (H.R. 3336) and Protecting Main Street End-Users From Excessive Regulation Act (H.R. 3527). Finally, the Agriculture Committee reported favorably on an exemption from certain Dodd-Frank regulations for some inter-affiliate swaps (H.R. 2779) and a bill to clarify the definition of swap execution facility (the Swap Execution Facility (SEF) Clarification Act (H.R. 2586)).

For further information regarding the CFTC’s implementation of Dodd-Frank, please contact the Sidley attorney with whom you regularly work.

⁸ Available at: <http://www.cftc.gov/PressRoom/Events/ssLINK/federalregister011112d>.

⁹ Sidley Austin LLP update on the proposed Volcker Rule available at: <http://www.sidley.com/files/News/32e665b6-8150-434f-ab91-2085a339e469/Presentation/NewsAttachment/8fb266e9-b0da-44e5-a0f7-2129e93c46e2/10.17.2011%20Financial%20Institution%20Regulation%20Update.pdf>.

¹⁰ Available at: <http://www.cftc.gov/PressRoom/Events/ssLINK/federalregister011112c>.

¹¹ Available at: <http://sec.gov/rules/proposed/2011/34-66057.pdf>.

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