



Dodd-Frank Financial Reform: Potential Impacts to ISDA and Other Trading Contracts

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Discussion Topics

- General Overview of the Dodd-Frank Act
- Title VII of the Dodd Frank Act: Impact on OTC Derivatives and Energy Trading
 - Definitions and applicability
 - Mandatory clearing
 - Registration requirements
 - Reporting & recordkeeping
 - Operational standards and business conduct requirements
 - Margin requirements and position limits



Dodd-Frank Act Overview

- On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”).
- The Act’s sweeping overhaul of the U.S. financial system was driven by the 2008-2009 financial crisis.
- Comprised of 16 Titles that directly impact banking and securities markets.



Dodd-Frank Act Overview (cont.)

- Key Impacts of the Act:
 - Creation of a independent Bureau of Consumer Financial Protection within the Federal Reserve Board
 - Power to wind down large, failing financial institutions
 - Creation of Financial Stability Oversight Council
 - Council of regulators across the Fed, OCC, FDIC, SEC and CFTC
 - Oversee systemic risk and strengthen regulation of financial holding companies
 - Volcker Rule: limitations on banks' ability (i) to engage in proprietary trading if not made on behalf of customers, and (ii) to invest in hedge funds or private equity funds



Dodd-Frank Act Overview (cont.)

- Key Impacts of the Act (cont.):
 - Strict capital and leverage requirements for financial institutions
 - Stringent oversight of the over-the-counter derivatives market, including mandatory clearing and real-time reporting of derivative trades
 - Stricter oversight of credit rating agencies, securitization reforms and expanded SEC enforcement powers
 - Expanded mortgage protections
 - Federal standards imposed on banks to ensure that borrowers can repay loans



Title VII: Over-the-Counter Derivatives Legislation

- “Wall Street Transparency and Accountability Act of 2010” (§§ 701, et. seq.)
- Imposes comprehensive regulatory framework for regulation of over-the-counter (“OTC”) derivatives
- Repeals regulatory exemptions for OTC derivatives previously relied upon by industry participants under the Commodity Exchange Act (“CEA”)
- Divides regulatory authority between the CFTC and SEC



Title VII: Over-the-Counter Derivatives Legislation (cont.)

- **Key Aspects of the Act Impacting OTC Derivatives and Energy Trading Counterparties:**
 - I. Definitions and Applicability
 - II. Mandatory Clearing
 - III. Registration Requirements
 - IV. Reporting and Recordkeeping
 - V. Operational Standards and Business Conduct Requirements
 - VI. Margin Requirements and Position Limits



I. § 721: Definitions and Applicability

- Does Dodd-Frank Apply? Key Definitions:
 - A. “Swap”
 - B. “Major Swap Participant”
 - C. “Swap Dealer”



A. § 721(a)(21): *Swap*

- The Act’s definition of “Swap” is very broad in scope and includes (but is not limited to) a commodity swap, an energy swap and an interest rate swap.
- The Act also contains exclusions to the definition of a Swap and regulations concerning master agreements under which Swaps are traded.
- **NOTE:** Neither a forward contract nor a physical option is considered a “Swap” under the Act.
 - Key: Do the parties intend to physically settle the transaction?

A. § 721(a)(21): *Swap* (cont.)

- Contracts themselves, not just Swap transactions, may qualify as Swaps under the Act.
- Thus, an ISDA Master Agreement itself—not just the relevant Swap transaction under the ISDA—is considered a Swap under the Act for purposes of such transaction.

A. § 721(a)(21): *Swap* (cont.)

- Likewise, any contract with a Swap component could cause the entire contract to be treated as a Swap for purposes of the Act, even if the primary focus of the contract does not relate to Swap obligations.
- **PRACTICE NOTE:**
 - Be careful entering into contracts with derivative components unless you are comfortable with the prospect of such contracts falling under the Act's requirements.

B. § 721(a)(16): Major Swap Participant

- General Definition: A person who:
 - (i) maintains a *substantial position* in Swaps (except positions held for *hedging or mitigating commercial risk or positions hedging employee benefit plan risk*);
 - (ii) whose outstanding Swaps create *substantial counterparty exposure* that could have serious adverse effects on the financial stability of the U.S. banking system; or
 - (iii) who is a *highly-leveraged Financial Entity* not subject to Federal banking agency requirements.



B. § 721(a)(16): Major Swap Participant (cont.)

- **Category 1**: A person who maintains a “substantial position” in any of the major Swap categories (*e.g.*, commodity swaps, energy swaps, interest rate swaps, etc.)
 - Most energy trading companies would likely fall under this category of a Major Swap Participant (if at all).
- **Exception**: If a person holds Swap positions for “hedging or mitigating commercial risk”, the person is not considered a Major Swap Participant.
 - CFTC’s Focus: Speculative trades or legitimate purpose to mitigate business risk?

B. § 721(a)(16): Major Swap Participant (cont.)

- What is a “substantial position” in a Swap?
 - *CFTC Proposed Rules: “Major Swap Participant” (75 Fed. Reg. 80, 173) (12/21/2010)*
- Two Objective Tests: A “substantial position” is one that meets CFTC thresholds under either of the following tests:
 - Current uncollateralized exposure; or
 - Current uncollateralized exposure *plus* potential future exposure



B. § 721(a)(16): Major Swap Participant (cont.)

- Four Swap Categories: The CFTC’s “substantial position” tests apply to a person’s Swap positions in each of four major swap categories:
 - Rate swaps;
 - Credit swaps;
 - Equity swaps; and
 - Other commodity swaps (including physical commodity swaps).
- **PRACTICE NOTE**: “Substantial position” tests do not apply to Swap positions hedging commercial risk or employee benefit plan positions.



B. § 721(a)(16): Major Swap Participant (cont.)

- Test 1 for “Substantial Position”: Current Uncollateralized Exposure:
 - Mark Swap positions to market using industry standard practices;
 - Deduct value of previously-posted collateral for the Swaps; and
 - Calculate exposure on a net basis, according to the terms of any master netting agreement that applies.
- Proposed Thresholds for Test 1: A “substantial position” exists in a category of Swaps if the *daily average current uncollateralized exposure* for such Swaps exceeds:
 - \$1 billion (credit, equity and commodity swaps); or
 - \$3 billion (interest rate swaps)



B. § 721(a)(16): Major Swap Participant (cont.)

- Test 2 for “Substantial Position”: Current Uncollateralized Exposure PLUS Potential Future Exposure:
 - Current Uncollateralized Exposure is calculated under Test 1
 - Mark-to-market of Swap positions; *minus*
 - Value of collateral previously-posted for such Swaps; *and*
 - Net aggregated Swap exposure based on any applicable master netting agreement.



B. § 721(a)(16): Major Swap Participant (cont.)

- Test 2 for “Substantial Position”: Current Uncollateralized Exposure PLUS Potential Future Exposure (cont.):
 - Potential future exposure is calculated as follows:
 - Total notional principal amount of Swap positions *multiplied by* specified risk factor percentages (ranging from ½% to 15%) based on the type of Swap and the duration of the position;
 - Discounting any positions subject to master netting agreements by a factor ranging between zero and 60%, depending on the effects of the agreement; and
 - If the Swaps are cleared or subject to daily mark-to-market margining, further discounting the amount of the positions by 80%.



B. § 721(a)(16): Major Swap Participant (cont.)

- Proposed Thresholds for Test 2: A “substantial position” exists in a category of Swaps if (i) the daily average current uncollateralized exposure for such Swaps, *plus* (ii) the potential future exposure for such Swaps exceeds:
 - \$2 billion (credit, equity and other commodity Swaps); or
 - \$6 billion (interest rate Swaps)



B. § 721(a)(16):

Major Swap Participant (cont.)

- **Major Swap Participant Exception**: Even if a person otherwise holds a “substantial position” in Swaps, they are *not* considered a Major Swap Participant if those positions are:
 - Held for “hedging or mitigating commercial risk”; or
 - Maintained by an employee benefit plan for hedging or mitigating risks in the operation of the plan.
- For energy trading companies, the key focus is on the CFTC’s interpretation of “hedging or mitigating commercial risk”.



B. § 721(a)(16): Major Swap Participant (cont.)

- “Hedging or Mitigating Commercial Risk”:
 - *CFTC Proposed Rules: “Major Swap Participant” (75 Fed. Reg. 80, 173) (12/21/2010)*
 - CFTC will analyze the facts and circumstances at the time the Swap is entered into and take into account the person’s overall hedging and risk mitigation strategies.

B. § 721(a)(16): Major Swap Participant (cont.)

- “Hedging or Mitigating Commercial Risk”: Swaps which “hedge or mitigate commercial risk” includes Swap positions that:
 - qualify as “bona fide hedges” under CEA rules;
 - qualify for hedging treatment under FASB Statement No. 133; or
 - are “economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise”, where the risks arise in the ordinary course of business from:
 - a potential change in the value of assets, liabilities or services; or
 - a potential change in value arising from interest rates, forex rates or other rate exposures.



B. § 721(a)(16): Major Swap Participant (cont.)

- “Hedging or Mitigating Commercial Risk”:
 - The CFTC’s proposed definition of “hedging or mitigating commercial risk” would not include any Swap position that is held for a purpose that is in the nature of speculation, investing or trading.

B. § 721(a)(16): Major Swap Participant (cont.)

- **PRACTICE NOTES:**

- CFTC Proposed Rules give guidance on whether parties may be excluded from the definition of a “Major Swap Participant”.
 - BUT NOTE: The CFTC still has discretion to determine whether a Swap “hedges or mitigates commercial risk” at the time the Swap is entered into.
- Even if Swap positions do not hedge commercial risk and are subject to “substantial position” tests, such positions still may be under the thresholds set by the CFTC.
- Even if a person is not a “Category 1” Major Swap Participant, two other categories in the definition may apply.



B. § 721(a)(16): Major Swap Participant (cont.)

- **Category 2:** A person whose outstanding Swaps create “substantial counterparty exposure” that could have serious adverse effects on the financial stability of the U.S. banking system.
- Definition of “Substantial Counterparty Exposure”: *CFTC Proposed Rules: “Major Swap Participant” (75 Fed. Reg. 80, 173) (12/21/2010)*
 - To determine “substantial counterparty exposure”, the CFTC uses the same general calculation methods used to calculate “substantial position” for a Category 1 MSP.
 - However, the definition of “substantial counterparty exposure”:
 - Relates to all Swap positions (not just four major categories); and
 - It does not exclude hedging or employee benefit plan positions.



B. § 721(a)(16):
Major Swap Participant (cont.)

- Proposed Thresholds for Category 2 MSPs: A person has “substantial counterparty exposure” if, across all of such person’s Swap positions, it has:
 - A current uncollateralized exposure of \$5 billion, or
 - A sum of current uncollateralized exposure and potential future exposure of \$8 billion.

B. § 721(a)(16): Major Swap Participant (cont.)

- **Category 3:** A person who is a highly-leveraged Financial Entity not otherwise subject to Federal banking agency capital requirements and maintains a substantial position in a major category of Swaps.
- Three Key Components:
 - Financial Entity;
 - Highly-leveraged; and
 - Substantial position in Swaps.



B. § 721(a)(16): Major Swap Participant (cont.)

- “Financial Entity”: *CFTC Proposed Rules: “Major Swap Participant” (75 Fed. Reg. 80, 173) (12/21/2010)*
 - The CFTC defines “Financial Entity” in Section 723(a)(3) of the Act, which creates an “end-user exception” to mandatory clearing if one party to a Swap is not a Financial Entity.
 - Generally, a Financial Entity includes (but is not limited to) a Major Swap Participant or a Swap Dealer.
 - **PRACTICE NOTE**: A Category 3 MSP is not subject to capital requirements set by Federal banking institutions. As a result, most banks and depository institutions will not be considered “Major Swap Participants”, but instead will be governed by separate regulations.



B. § 721(a)(16): Major Swap Participant (cont.)

- “Highly-Leveraged”: *CFTC Proposed Rules: “Major Swap Participant”* (75 Fed. Reg. 80, 173) (12/21/2010)
 - The CFTC’s rules propose two possible definitions—either:
 - A ratio of total liabilities to equity (as determined in accordance with GAAP) of 8 to 1; or
 - A ratio of 15 to 1, measured in the same way.
 - **PRACTICE NOTE:**
 - The CFTC has not finalized its proposed rules, so the above-stated ratios are subject to change.



B. § 721(a)(16): Major Swap Participant (cont.)

- “Substantial Position” in Swaps: *CFTC Proposed Rules: “Major Swap Participant” (75 Fed. Reg. 80, 173) (12/21/2010)*
 - CFTC uses the same definition and calculation of a “substantial position” as used with Category 1 MSPs.
 - However, no exceptions for Swaps that hedge or mitigate commercial risk or relate to employee benefit plans.



C. § 721(a)(21): *Swap Dealer*

- General Definition: A “Swap Dealer” includes (but is not limited to) one who “regularly enters into Swaps with counterparties as an ordinary course of business for its own account.”
 - The terms “regularly” and “ordinary course of business” are not defined in the Act.
- A Swap Dealer does *not* include a person that:
 - Enters into Swaps for its own account, but *not* as a part of its regular business; or
 - Engages in a “de minimus” quantity of Swaps in connection with transactions with or on behalf of its customers.



C. § 721(a)(21): Swap Dealer (cont.)

- Characteristics of a Swap Dealer: *CFTC Proposed Rules: “Swap Dealer” (75 Fed. Reg. 80, 173) (12/21/2010)*
 - Tends to accommodate demand for Swaps from other parties;
 - Generally is available to enter into Swaps to facilitate other parties’ interest in entering into Swaps;
 - Tends not to request that other parties propose the terms of Swaps, but instead enter into Swaps on their own standard terms or on terms they arrange in response to other parties’ interests; and
 - Tends to be able to arrange customized terms for Swaps upon request, or to create new types of Swaps at their own initiative.

C. § 721(a)(21): *Swap Dealer (cont.)*

- “De Minimus” Exemption: A person is not a Swap Dealer if:
 - The aggregate effective notional amount, measured on a gross basis, of the Swaps that the person entered into over the prior 12 months in connection with dealing activities does not exceed \$100 million;
 - The aggregate effective notional amount of such Swaps with “special entities” over the prior 12 months does not exceed \$25 million;
 - “Special Entities” include certain governmental entities
 - The person has not entered into Swaps with more than 15 counterparties (other than security-based swap dealers) over the prior 12 months; and
 - The person has not entered into more than 20 Swaps as a dealer over the prior 12 months.



C. § 721(a)(21): *Swap Dealer (cont.)*

- **PRACTICE NOTES:**

- On its face, the term “Swap Dealer” seems to cover most energy trading Swap participants—even those who enter into Swaps for hedging purposes—by including any entity that “regularly enters into Swaps with counterparties as an ordinary course of business for its own account”.
- Such definition appears contrary to Congressional intent:
 - In a letter dated June 30, 2010 from Senators Dodd and Lincoln to Representatives Frank and Peterson (the “Dodd-Lincoln Letter”), the Senators explain that “end users should not be treated as Swap Dealers simply because they regularly use Swaps to hedge risk.”
- Broad language in the Act seems contrary to recent CFTC proposed rules, which provide more narrow, specific characteristics of a Swap Dealer.



II. § 723(a)(3): Mandatory Clearing

- Topics for Discussion:
 - A. General Clearing Determination and Procedures
 - B. End-User Exception to Mandatory Clearing
 - C. Affiliate Transactions
 - D. Clearing Transition Rules: Pre-Enactment and Transition Swaps
 - E. § 724: Segregation Rules for Uncleared Swaps



A. General Clearing Determination and Procedures

- **General Rule**: A Swap *must* be cleared through a registered derivatives clearing organization (“DCO”) if the CFTC, after analyzing a variety of factors, determines that such Swap must be cleared.
- **Procedure for Reviewing Swaps**: The CFTC will review Swaps to determine whether or not they must be cleared either by (i) receiving information about a Swap from a DCO or Swap data repository (“SDO”); or (ii) initiating its own review.
 - Information on Swaps may be made available to the public.
 - Public comment period before CFTC finalizes its clearing determination.

A. General Clearing Determination and Procedures (cont.)

- **Clearing Determination from DCO Swap Data:** Generally, DCOs must submit types or categories of cleared Swaps to the CFTC for review.
 - DCO is presumed eligible to accept for clearing any Swaps that the DCO already clears.
 - If DCO plans to clear new type or category of Swap, must submit the Swap to the CFTC for determination.
- **Clearing Determination from CFTC-Initiated Review:** CFTC will continually monitor Swaps that are not cleared through DCOs and determine whether they are subject to mandatory clearing.



A. General Clearing Determination and Procedures (cont.)

- **Transactions with Non-MSPs and Non-SDs:**
 - If a Swap *is* required to be cleared and the relevant counterparty is not an MSP or SD, such counterparty has the right to select the DCO used for clearing.
 - If a Swap is *not* required to be cleared and the relevant counterparty is not an MSP or SD, such counterparty has the right to:
 - Require that the parties clear the Swap; and
 - Select the DCO used for clearing.

A. General Clearing Determination and Procedures (cont.)

- **PRACTICE NOTES:**

- Note that the general mandatory clearing requirement is not specific to MSPs or SDs—it could apply to any party to a Swap.
 - Non-MSPs or Non-SDs should confirm whether the End-User Exception applies.
- Whether a Swap or category of Swaps is required to be cleared is a moving target subject to CFTC determination.
 - Parties will need to monitor CFTC rulemakings.



A. General Clearing Determination and Procedures (cont.)

- **PRACTICE NOTES (cont.):**
 - Special clearing rules apply when dealing with Non-MSPs or Non-SDs
 - Even if Swap is not required to be cleared, clearing still may apply.
 - MSPs and SDs may be required to use different DCOs than they otherwise would select, depending on the election of the counterparty.



B. End-User Exception to Clearing

- Generally: A Swap otherwise subject to mandatory clearing is subject to an elective exception from clearing if:
 - At least one party to the Swap is not a Financial Entity;
 - Such party is using the Swap to hedge or mitigate commercial risk; *and*
 - Notice is provided to the CFTC regarding how it generally meets its financial obligations associated with entering into non-cleared Swaps.



B. End-User Exception to Clearing (cont.)

- Definition of “End-User”: *CFTC Proposed Rule on End-User Exception to Mandatory Clearing of Swaps (75 Fed. Reg. 80,747) (12/23/2010)*
 - An “**End User**” is a non-Financial Entity that is using Swaps to hedge or mitigate its commercial risks (meets the first 2 prongs of the exception).
- Definition of “**Financial Entity**”:
 - Laundry list of parties stated in § 723(a)(3)
 - Expressly includes Major Swap Participant and Swap Dealer

B. End-User Exception to Clearing (cont.)

- “Hedging or Mitigating Commercial Risk”: Same meaning as in the definition of Major Swap Participant. Swap positions “hedge or mitigate commercial risk” if they:
 - Qualify as “bona fide hedges” under CEA rules;
 - Qualify for hedging treatment under FASB Statement No. 133; or
 - Are “economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise”, where the risks arise in the ordinary course of business from changes in the value of assets, liabilities or services.



B. End-User Exception to Clearing (cont.)

- Notification Requirement for End-User Exception: CFTC Proposed Rule on End-User Exception to Mandatory Clearing of Swaps (75 Fed. Reg. 80,747) (12/23/2010)
 - End User must notify the CFTC of how it generally meets its financial obligations associated with entering into non-cleared Swaps.
 - Under the proposed rules, notice must be provided through an SDR.
 - CFTC will publish a “user-friendly” check-the-box form for End Users to submit to an SDR when a Swap is executed:
 - Describe how credit risk is mitigated in the absence of clearing;
 - Disclose if an affiliate or Financial Entity is involved in the deal;
 - Statement that the Swap is being used for hedging purposes; and
 - Other commercial terms relating to the Swap.



B. End-User Exception to Clearing (cont.)

- Possible Exception for Small Financial Institutions: CFTC Proposed Rule on End-User Exception to Mandatory Clearing of Swaps (75 Fed. Reg. 80,747) (12/23/2010)
 - Generally, a financial institution is a “Financial Entity” and thus it does not qualify as an End User able to elect the clearing exception.
 - The CFTC is considering exempting small banks, savings associations, farm credit system institutions and credit unions from the definition of “Financial Entity” used in the End User exception



C. Affiliate Transactions

- Affiliates and the End User Exception: *CFTC Proposed Rule on End-User Exception to Mandatory Clearing of Swaps (75 Fed. Reg. 80,747) (12/23/2010)*
 - An affiliate may qualify for the clearing exception if such affiliate, acting on behalf of and as agent for a person or other affiliate that qualifies for the clearing exception, uses the Swap to hedge or mitigate commercial risk of the qualifying person or other affiliate that is not a Financial Entity.
- Why is this important?
 - Affiliates may serve as asset or energy managers for qualifying End Users.
 - Use of non-qualifying affiliate does not hinder clearing exception.

D. Clearing Transition Rules

- The CFTC has clarified how it will handle those Swaps that would otherwise be subject to clearing under the Act, but:
 - The Swaps were entered into *prior to enactment* of Dodd-Frank on July 21, 2010 and *had not yet expired* as of such date (“*Pre-Enactment Unexpired Swaps*”); or
 - The Swaps were entered into *on or after enactment* of Dodd-Frank on July 21, 2010, but *prior to the effective date* of the CFTC’s final Swap data reporting rules (“*Transition Swaps*”).



D. Clearing Transition Rules (cont.)

- CFTC's General Transition Rule:
 - The CFTC requires that Pre-Enactment Unexpired Swaps and Transition Swaps be reported to SDRs or the CFTC within the time frames established under the Act and the CFTC's rules.
 - If such Swaps are timely reported, they will be exempt from further clearing requirements under the Act.
 - Pre-enactment Swaps that expired prior to July 21, 2010 are not required to be reported.



D. Clearing Transition Rules (cont.)

- Pre-Enactment Unexpired Swaps: *Interim Final Rule Regarding Reporting of Pre-Enactment Swap Transactions (75 Fed. Reg. 63,080) (10/14/2010)*
 - Who Must Report Swap Data? Per § 729 of the Act's reporting requirements:
 - For Swaps in which only one party is an MSP or SD, the MSP or SD is required to report the Swap data.
 - For Swaps in which one party is an MSP and the other party is an SD, the SD is required to report the Swap data.
 - For any other Swaps, the parties must select the reporting party.



D. Clearing Transition Rules (cont.)

- Pre-Enactment Unexpired Swaps (cont.): *Interim Final Rule Regarding Reporting of Pre-Enactment Swap Transactions (75 Fed. Reg. 63,080) (10/14/2010)*
 - What Information Must be Retained and Reported? Each counterparty to a Pre-Enactment Unexpired Swap should retain the following in anticipation of finalized reporting requirements:
 - Any information necessary to identify and value the Swap;
 - The date and time of execution;
 - Information about the price and notional volume of the transaction;
 - Whether the Swap was accepted for clearing and the identity of the DCO;
 - Any modifications to the Swap; and
 - The final confirmation of the Swap transaction.

D. Clearing Transition Rules (cont.)

- Pre-Enactment Unexpired Swaps (cont.): *Interim Final Rule Regarding Reporting of Pre-Enactment Swap Transactions (75 Fed. Reg. 63,080) (10/14/2010)*
 - Timing: Information on Pre-Enactment Unexpired Swaps must be reported to a registered SDR or the CFTC by the earlier of:
 - 60 days following registration of the appropriate SDR; or
 - The compliance date for establishing permanent reporting rules under Section 2(h)(5) of the CEA (*i.e.*, no later than January 12, 2012)



D. Clearing Transition Rules (cont.)

- Transition Swaps: *Interim Final Rule Regarding Reporting of Certain Post-Enactment Swap Transactions (75 Fed. Reg. 78,892) (12/17/2010)*
 - Who Must Report Swap Data? The same designated parties that report data on Pre-Enactment Unexpired Swaps:
 - For Swaps in which only one party is an MSP or SD, the MSP or SD is required to report the Swap data.
 - For Swaps in which one party is an MSP and the other party is an SD, the SD is required to report the Swap data.
 - For any other Swaps, the parties must select the reporting party.



D. Clearing Transition Rules (cont.)

- Transition Swaps (cont.): *Interim Final Rule Regarding Reporting of Certain Post-Enactment Swap Transactions (75 Fed. Reg. 78,892) (12/17/2010)*
 - What Information Must be Retained and Reported? Each counterparty to a Transition Swap should retain the following in anticipation of finalized reporting requirements:
 - Any information necessary to identify and value the Swap;
 - The date and time of execution;
 - Information about the price and notional volume of the transaction;
 - Whether the Swap was accepted for clearing and the identity of the DCO;
 - Any modifications to the Swap; and
 - The final confirmation of the Swap transaction.



D. Clearing Transition Rules (cont.)

- Transition Swaps (cont.): *Interim Final Rule Regarding Reporting of Certain Post-Enactment Swap Transactions (75 Fed. Reg. 78,892) (12/17/2010)*
 - Timing:
 - Per the Act's terms, the obligation to report Transition Swap data became effective on the date Dodd-Frank was enacted (*i.e.*, July 21, 2010).
 - However, reporting deadlines do not arise until the later of:
 - 90 days after July 15, 2011 (the effective date of the Act); or
 - Such other time as the CFTC may prescribe by rule.



D. Clearing Transition Rules (cont.)

- **PRACTICE NOTES:** Clearing Transition Rules
 - At this point, no SDRs have registered with the CFTC and permanent reporting requirements are still being finalized by the Commission.
 - However, the Interim Final Rules for both Pre-Enactment Unexpired Swaps and Transition Swaps call on all counterparties to retain Swap information in anticipation of reporting.
 - To ensure compliance with the Act, counterparties may need to analyze internal operations to confirm that information required by the CFTC is being properly retained.
 - Counterparties also should monitor CFTC rulemaking updates to ensure compliance with upcoming reporting deadlines.



E. § 724: Segregation Rules for Uncleared Swaps

- § 724(c) General Rule: Even if a Swap is not required to be cleared under the Act's mandatory clearing requirements, MSPs and SDs have a duty to notify counterparties that, with respect to any "initial margin" posted by the counterparty relating to the uncleared Swap, the counterparty has a right to require that such margin be segregated and held by an independent custodian.
- To implement the Act's requirements, the CFTC has issued a *Proposed Rulemaking on Protection of Collateral of Counterparties to Uncleared Swaps* (75 Fed. Reg. 75,432) (12/3/2010).



E. § 724: Segregation Rules for Uncleared Swaps (cont.)

- Scope of the Proposed Rule:
 - Addresses the counterparty’s right (not obligation) to require that “initial margin” for an uncleared Swap be held in a segregated account and gives details about such account.
 - Requires that a counterparty’s chief risk officer, chief executive officer, or similar high-level decision maker be advised of such right.
- The Proposed Rule Does NOT:
 - Require that initial margin be segregated—this is solely at counterparty’s election; or
 - Address how much or what type of margin should be segregated.



E. § 724: Segregation Rules for Uncleared Swaps (cont.)

- Initial Margin v. Variation Margin: Notably, the counterparty’s segregation election under § 724 only applies with respect to “initial margin”—not “variation margin”.
 - “Initial Margin”: an amount calculated based on anticipated exposure to future changes in the value of a Swap.
 - “Variation Margin”: an amount calculated to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market.



E. § 724: Segregation Rules for Uncleared Swaps (cont.)

- Initial Margin v. Variation Margin (cont.): Further clarification from the CFTC seems necessary.
 - Based on the Proposed Rule, does segregation only apply to an *initial* calculation of “anticipated exposure” when the Swap is entered into?
 - What about any ongoing collateral requirements under the Credit Support Annex (ISDA) or Collateral Annex (EEI) where forward exposure is calculated based on then-current mark-to-market? Would such collateral be “variation margin” because it covers “current exposure” and not “anticipated exposure”?
 - The practical impact of the segregation requirements (and the interplay with the structure of the ISDA or EEI) remains to be seen.



E. § 724: Segregation Rules for Uncleared Swaps (cont.)

- Requirements for Segregated Accounts:
 - Account must be held at a custodian that is independent of both the counterparty and the SD or MSP.
 - NOTE: The Proposed Rule does *not* specify who chooses the custodian.
 - There must be a written custody agreement which meets certain CFTC requirements.
 - Example: “Turnover of control shall be made promptly upon presentation of statement, in writing, signed by authorized person under penalty of perjury that one party is entitled to such turnover pursuant to an agreement between the parties.”



E. § 724: Segregation Rules for Uncleared Swaps (cont.)

- Requirements for Segregated Accounts (cont.):
 - Margin in segregated accounts may be invested pursuant to CFTC Rule 1.25 (which governs the investment of property owned by futures customers).
 - **The Proposed Rule does not clarify whether the cost of a segregated account must be disclosed by the MSP or SD, nor does it state who actually pays for custodial fees and costs involved in establishing the segregated account (*e.g.*, negotiating the custodial agreement, etc.).



E. § 724: Segregation Rules for Uncleared Swaps (cont.)

- No Limitation on Forms of Collateral:
 - The CFTC has clearly stated that the Proposed Rule is *not* intended to limit the types of margin that a customer may post.
 - Thus, a Credit Support Annex (ISDA) or Collateral Annex (EEI) still would determine (i) the amount of margin that must be posted, and (ii) the types of collateral permitted under the parties' agreement.
 - NOTE: What is the impact of a segregation election if parties only use letters of credit instead of cash?



E. § 724: Segregation Rules for Uncleared Swaps (cont.)

- What if a Counterparty Does Not Elect Segregation?
 - Quarterly Report: The MSP or SD must send the counterparty a quarterly report verifying that “the back office procedures of the swap dealer or major swap participant relating to margin and collateral requirements are in compliance with the agreement of the counterparties.”
 - Timing: MSP’s or SD’s chief compliance officer must send the report no later than the 15th business day of each calendar quarter following the quarter to which the report applies.



E. § 724: Segregation Rules for Uncleared Swaps (cont.)

- **PRACTICE NOTES:**

- Just because a Swap is not subject to mandatory clearing does not mean that an MSP/SD is “off the hook”:
 - Notice requirement disclosing segregation election;
 - Potential segregation/custodian obligations; and
 - Even if segregation not elected, quarterly reporting.
- Use of custodian and segregated account create additional costs that currently are not allocated by the CFTC’s Proposed Rule.
 - It seems reasonable that such costs would be borne by the counterparty electing segregation, but the CFTC has not finalized this issue.



III. § 731: Registration Requirements

- Key Concepts:
 - A. Who is required to register?
 - B. When is registration required?
 - C. What are the details of provisional registration?
 - D. Who conducts ongoing compliance reviews of registered entities?



A. Who is Required to Register?

- General Rule (§ 731—adding CEA § 4s(a)):
 - It is unlawful for any person to act as a *Swap Dealer* or *Major Swap Participant* unless such person is registered with the CFTC.
- CFTC Rulemaking:
 - To clarify the Act's registration requirements, the CFTC has recently released its *Proposed Rules Regarding Registration of Swap Dealers and Major Swap Participants* (75 Fed. Reg. 71,379) (11/23/2010)

B. When is Registration Required?

- The Proposed Rules clarify that:
 - Registration will not be mandatory until the CFTC finalizes rules defining “Swap Dealer” or “Major Swap Participant”.
 - However, beginning April 15, 2011, parties who believe that they are Swap Dealers or Major Swap Participants will be *permitted* (not required) to register on a provisional basis.



C. Provisional Registration

- Provisional Registration: After April 15, 2011, a person may file a registration application with the CFTC as a Swap Dealer or Major Swap Participant, even though:
 - Final rules on the Act's definitions may not be established; and
 - Final rules regarding MSP/SD compliance requirements added by § 731 of the Act (*e.g.*, reporting, capital and margin requirements, business conduct standards, etc.) may not yet be effective.
- Effect of Provisional Registration: Registrants are subject only to those CFTC requirements (if any) that are in effect when they file their registration application.
 - CFTC permits registrants to come into compliance with requirements only when they become finalized and effective.



D. Who Conducts Ongoing Compliance of Registered Entities?

- The CFTC is considering three options:
 - Option 1: CFTC ensures compliance with all CEA and CFTC requirements.
 - Option 2: The National Futures Association (“NFA”) would ensure compliance, subject to CFTC oversight.
 - Option 3: Certain oversight activities performed by the CFTC, and other activities performed by the NFA.
- NOTE: Under the Proposed Rules, all MSPs and SDs would be required to become part of a registered futures association.
 - May be subject to additional membership procedures and requirements apart from CFTC regulations.

IV. Reporting and Recordkeeping

- Key Requirements:*
 - A. § 727: Real-Time Public Reporting
 - B. § 729: Reporting and Recordkeeping (SDRs)
 - C. § 731: Reporting and Recordkeeping (CFTC)
- *Note that additional reporting obligations may apply to MSPs and SDs under the Clearing Transition Rules of § 723 (previously discussed in Section II(D) herein).

A. § 727: Real-Time Public Reporting

- General Public Reporting Rule Under the Act:
 - Certain transaction data for all Swaps (whether cleared or uncleared, and regardless of execution method) must be made publicly available “as soon as technologically practicable” after the Swap has been “executed”.
 - Reported information must not identify the participants to the Swap transaction.
- CFTC Rulemaking: *Proposed Rule on Real-Time Public Reporting of Swap Transaction and Pricing Data* (75 Fed. Reg. 76,139) (12/7/2010)



A. § 727: Real-Time Public Reporting (cont.)

- Parties Responsible for Reporting:
 - On-Facility Transactions: If a Swap is executed on a Swap execution facility (“SEF”) or a designated contract market (“DCM”) (e.g., ICE or NYMEX), the parties satisfy their public reporting obligations by executing the Swap on the facility.
 - The relevant SEF or DCM reports the parties’ Swap data to a “real-time disseminator” as soon as technologically practicable following execution.
 - “Real-Time Disseminator”: (i) an SDR that accepts data for a particular Swap class; or (ii) a third-party service provider that accepts and disseminates Swap data to the public.



A. § 727: Real-Time Public Reporting (cont.)

- Parties Responsible for Reporting (cont.):
 - Off-Facility Transactions: If a Swap is executed off-exchange (*i.e.*, not through an SEF or DCM), the following parties must report Swap data to a real-time disseminator:
 - If one party is an SD and the other is an MSP, the SD reports;
 - If only one party is an SD or MSP and the other party is not, the SD or MSP reports; and
 - In all other cases (*e.g.*, both parties are—or are not—MSPs or SDs), the parties decide which of them will report Swap data.



A. § 727: Real-Time Public Reporting (cont.)

- Data To Be Reported:
 - The Proposed Rule lists certain types of data affecting the price of the Swap that must be publicly reported, including but not limited to:
 - Contract type (*e.g.*, commodity swap, interest rate swap, etc.);
 - Underlying asset class and/or commodity type;
 - Tenor of the Swap; and
 - Payment frequency.

A. § 727: Real-Time Public Reporting (cont.)

- Timing of Reporting: “As soon as technologically practicable” following the “execution” of a Swap
 - “As soon as technologically practicable”: Per the Proposed Rules, this means “as soon as possible, taking into consideration the prevalence, implementation and use of technology by comparable market participants.”
 - NOTE: Block trades and large notional trades meeting CFTC minimum size requirements are subject to a 15-minute delay in reporting.



A. § 727: Real-Time Public Reporting (cont.)

- Timing of Reporting (cont.): “As soon as technologically practicable” following “execution” of a Swap
 - “Execution”: Per the Proposed Rules –
 - “An agreement by the parties (whether orally, in writing, electronically or otherwise) to the terms of a Swap that legally binds the parties to such Swap terms under applicable law.”



A. § 727: Real-Time Public Reporting (cont.)

- Timing of Reporting (cont.): “As soon as technologically practicable” following “execution” of a Swap
 - “Execution” (cont.): Per the Proposed Rules—
 - Occurs immediately following (or simultaneous with) the “affirmation” of a Swap.
 - “Affirmation” occurs when the parties verify (orally, in writing electronically or otherwise) that they agree on the primary economic terms of a Swap (but not necessarily all terms of the Swap).
 - Affirmation may constitute execution of a Swap, or may simply be evidence of execution of a Swap, but it is not the same as confirmation of a Swap.



A. § 727: Real-Time Public Reporting (cont.)

- **PRACTICE NOTES:**

- Counterparties should be aware of (i) whether they need to report; and (ii) the identity of the “real-time disseminator” to whom they report.
- May need to update internal operations to ensure that required data is reported “as soon as technologically practicable”.
 - Do your systems allow you to electronically submit Swap data as soon as possible?
 - Should relevant Swap data be immediately pulled and input into a report when a Swap is “executed”?

A. § 727: Real-Time Public Reporting (cont.)

- **PRACTICE NOTES:**

- CFTC reporting obligations arise upon “execution”, which may occur before the parties actually sign any confirmation.
 - This may differ from confirmation procedures agreed-upon by the parties under the ISDA/EEI (*e.g.*, written confirmation procedure).
 - Proposed Rule clarifies that “execution” may arise even if all terms of the Swap are not yet finalized.
- Confidentiality provisions may need to be updated to take into account CFTC public reporting obligations.



B. § 729: Reporting and Recordkeeping (SDRs)

- General Reporting Rule Under § 729:
 - At least one counterparty to a Swap must report specific data concerning the Swap to a registered SDR.
 - If an SDR does not accept the Swap data, the counterparty must report such Swap data directly to the CFTC.
 - If the Swap is cleared through a DCO, the DCO reports Swap data on the parties' behalf.
- CFTC Rulemaking: *Proposed Rule on Swap Data Recordkeeping and Reporting* (75 Fed. Reg. 76,573) (12/8/2010)



B. § 729: Reporting and Recordkeeping (SDRs) (cont.)

- Distinction in Reporting Rules:
 - § 727: Real-time reporting of Swap transaction data to a “real-time disseminator” for public distribution.
 - NOTE: In certain cases the SDR may be the “real-time disseminator”
 - § 729: Recordkeeping and reporting of Swap data to an SDR (or if not accepted by an SDR, the CFTC) for use by regulators.
- § 728: Swap Data Repository (“SDR”): registered entity that collects and maintains data related to Swaps (as prescribed by the CFTC) and makes such data available to regulators.



B. § 729: Reporting and Recordkeeping (SDRs) (cont.)

- What Types of Data Must Be Reported? Data from two important stages of a Swap's existence:
 - The creation of a Swap ("Swap Creation Data"):
 - Primary economic terms
 - Confirmation
 - The continuation of a Swap over its existence until its final termination or expiration ("Swap Continuation Data"):
 - *Credit/Equity Swaps*: Life cycle event data, contract-intrinsic (scheduled) event data, and specified valuation data; and
 - *Interest Rate, Currency and Commodity Swaps*: daily snapshot of primary economic terms, and valuation data.



B. § 729: Reporting and Recordkeeping (SDRs) (cont.)

- Who is Required to Report Swap Data to the SDR? Depends on the following factors:
 - The type of data being reported (*e.g.*, Swap Creation Data v. Swap Continuation Data);
 - Whether executed on-exchange (*i.e.*, through an SEF or DCM) or off-exchange; and
 - Whether cleared through a DCO.

B. § 729: Reporting and Recordkeeping (SDRs) (cont.)

Reporting of Swap Creation Data				
Reporting Counterparty	Executed on a trading platform and cleared	Executed on a trading platform and not cleared	Not executed on a trading platform and cleared	Not executed on a trading platform and not cleared
SDs and MSPs	SEF/DCM (primary economic terms) DCO (confirmation)	SEF/DCM (primary economic terms) SD/MSP (confirmation)	SD/MSP (primary economic terms) DCO (confirmation)	SD/MSP (primary economic terms) SD/MSP (confirmation)
Non-SD/MSP Counterparties	SEF/DCM (primary economic terms) DCO (confirmation)	SEF/DCM (primary economic terms) Non-SD/MSP (confirmation)	Non-SD/MSP (primary economic terms) DCO (confirmation)	Non-SD/MSP (primary economic terms) Non-SD / MSP (confirmation)



B. § 729: Reporting and Recordkeeping (SDRs) (cont.)

Reporting of Swap Continuation Data				
Reporting Counterparty	Credit and Equity Swaps		Interest Rate, Currency, and Other Commodity Swaps	
	Cleared	Not Cleared	Cleared	Not Cleared
SDs and MSPs	DCO (life cycle data) DCO and SD/MSP (valuation data) SD/MSP (intrinsic data)	SD/MSP (life cycle data) SD/MSP (valuation data) SD/MSP (intrinsic data)	SD/MSP (daily snapshot of primary economic terms data) DCO and SD/MSP (valuation data)	SD/MSP (daily snapshot of primary economic terms data) SD/MSP (valuation data)
Non-SD/MSP Counterparties	DCO (life cycle data) DCO (valuation data) Non-SD/MSP (intrinsic data)	Non-SD/MSP (life cycle data) Non-SD/MSP (valuation data) Non-SD/MSP (intrinsic data)	Non-SD/MSP (daily snapshot of primary economic terms data) DCO (valuation data)	Non-SD/MSP (daily snapshot of primary economic terms data) Non-SD/MSP (valuation data)



B. § 729: Reporting and Recordkeeping (SDRs) (cont.)

- Recordkeeping Requirements:
 - Records must be “readily accessible” (i) throughout the existence a Swap, and (ii) for *two years* after termination or expiration of the Swap.
 - Records must be kept (i) throughout the existence of a Swap, and (ii) for *five years* after termination or expiration of the Swap.

B. § 729: Reporting and Recordkeeping (SDRs) (cont.)

- **PRACTICE NOTES:**

- Determine whether you are required to report, and if so, the SDR to whom you must report Swap data.
- Ensure that you have systems in place to monitor and report Swap Creation Data and Swap Continuation Data as required.
- Determine whether data retention and storage policies need to be updated to comply with CFTC recordkeeping obligations.
 - “Readily accessible” for at least 2 years after termination or expiration of Swap; and
 - Maintained for at least 5 years after termination or expiration of Swap.



C. § 731: Reporting and Recordkeeping (CFTC)

- General Requirements: § 731 of the Act and the *Proposed Rule on Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants* (75 Fed. Reg. 76,666) (12/9/2010):
 - MSPs and SDs must “make such reports as required by the Commission by rule or regulation regarding the transactions and positions and financial condition” of the SD or MSP.
 - All books and records of SDs and MSPs are open to inspection and examination by any CFTC representative.
 - MSPs and SDs must create daily trading records during the life of each Swap (pre-execution, execution and post-execution data) and report such data according to real-time and SDR reporting rules.

C. § 731: Reporting and Recordkeeping (CFTC) (cont.)

- Recordkeeping Rules: MSPs and SDs must abide by the following:
 - Swap Records: Keep full and complete transaction and position information for all Swap activities on a daily basis, including all documents on which trade information is originally recorded.
 - Records must be maintained in a manner that is identifiable and searchable by transaction and by counterparty.
 - Business Records: Keep basic business records, including minutes from meetings of the governing body, organizational charts, audit documentation, financial records, records of complaints against personnel and marketing materials.
 - SDR and Real-Time Data: Maintain records of data required to be submitted on a real-time basis or to an SDR.

C. § 731: Reporting and Recordkeeping (CFTC) (cont.)

- Daily Trading Records: MSPs and SDs must maintain records of pre-execution, execution and post-execution Swap data in order for the CFTC to have a “complete audit trail for conducting comprehensive and accurate trade reconstructions”.
- Pre-Execution Data: Records of all oral and written communications that lead to the execution of a Swap:
 - Telephone recordings and voicemails;
 - Facsimiles;
 - Instant messages and chat room messages;
 - Email;
 - Mobile device messages;
 - Other digital or electronic media.



C. § 731: Reporting and Recordkeeping (CFTC) (cont.)

- Daily Trading Records (cont.):
 - Execution Data:
 - All terms of each executed Swap;
 - Date and time, to the nearest minute, when each Swap was executed.
 - Post-Execution Data:
 - Records of all confirmations, reconciliations and margining requirements related to each Swap.
- Hedging Data:
 - Apart from Swap data requirements, MSPs and SDs also must keep records of all cash or forward transactions used to hedge, mitigate the risk of, or offset any Swap held by the MSP or SD.



C. § 731: Reporting and Recordkeeping (CFTC) (cont.)

- **PRACTICE NOTES:**

- The CFTC's requirements are numerous and detailed.
 - MSPs and SDs should become intimately familiar with the types of data that must be maintained, stored and/or reported.
- Open inspection and examination of records subject MSPs and SDs to scrutiny at the CFTC's discretion.
 - Be prepared to avoid any compliance issues.



C. § 731: Reporting and Recordkeeping (CFTC) (cont.)

- **PRACTICE NOTES:**

- Operational policies and data storage and retention plans will need to be scrutinized for compliance.
 - This is particularly true with respect to daily trading requirements, which include recording and storage of *all* pre-execution data.
- § 731 requirements work in conjunction with—and do not replace—any other reporting and recordkeeping obligations under the Act.
 - *E.g.*, Real-time public reporting (§ 727) and SDR reporting obligations (§ 729).



V. Operational Standards and Business Conduct Requirements

- Topics for Discussion:
 - A. Duties of SDs and MSPs
 - B. Conflicts of Interest for SDs and MSPs
 - C. Designation of Chief Compliance Officer
 - D. Business Conduct Standards
 - E. Confirmation and Portfolio Requirements



A. Duties of SDs and MSPs

- § 731: General Duties Imposed on SDs and MSPs:
 - Monitor trading to prevent violations of position limits;
 - Establish risk management procedures adequate for managing the SD's or MSP's day-to-day business;
 - Disclose to the CFTC general information relating to Swap trading practices and financial integrity;
 - Establish and enforce internal systems and procedures necessary to abide by all CFTC requirements;
 - Implement conflict of interest systems;
 - Do not take any action resulting in an unreasonable restraint of trade or anticompetitive burden on trading or clearing.



A. Duties of SDs and MSPs (cont.)

- CFTC Rulemaking: *Proposed Rule on Duties for Swap Dealers and Major Swap Participants* (75 Fed. Reg. 71,397) (11/23/2010)
 - Goal: Sets forth specific business conduct standards for SDs and MSPs to ensure compliance with the general duties required under the Act.
 - Standards Promulgated by the Proposed Rule:
 - Risk management procedures;
 - Monitoring and trading;
 - Diligent supervision;
 - Business continuity and disaster recovery;
 - Disclosure and inspection of information; and
 - Antitrust considerations.



A. Duties of SDs and MSPs (cont.)

- Risk Management Procedures:
 - Under the Proposed Rule, the risk management policies and procedures of SDs and MSPs must take into account market risk, credit risk, liquidity risk, foreign currency risk, legal risk, operational risk, settlement risk, and all other relevant risks.
 - SDs and MSPs must establish policies to monitor traders throughout the trading day to ensure compliance with (i) position limits, and (ii) transaction execution and confirmation procedures.
 - Risk management policies must institute a strict separation of traders from the MSP's or SD's risk management unit.



A. Duties of SDs and MSPs (cont.)

- Monitoring and Trading:
 - SDs and MSPs must establish procedures to monitor and prevent violations of applicable position limits established by the CFTC, a DCM or an SEF.
 - Such monitoring and prevention procedures must:
 - Provide annual training for personnel;
 - Diligently monitor and supervise trading;
 - Implement an early warning system;
 - Test position limit procedures;
 - Document compliance with position limits quarterly; and
 - Audit the procedures annually



A. Duties of SDs and MSPs (cont.)

- Diligent Supervision: MSPs and SDs must—
 - Establish a system of diligent supervision over all activities performed by its partners, members, officers, employees, and agents; and
 - Create a supervisory system with qualified supervisory personnel.
- Business Continuity and Disaster Recovery:
 - MSPs and SDs must establish a business continuity and disaster recovery plan designed to enable them to resume operations by the next business day following an emergency or other disruption.



A. Duties of SDs and MSPs (cont.)

- Disclosure and Inspection of Information:
 - SDs and MSPs must promptly disclose all information required by the CFTC by having adequate internal systems that permit the CFTC to obtain any information required in a timely manner.
- Antitrust Considerations:
 - SDs and MSPs must adopt policies and procedures to prohibit any action that results in any unreasonable restraint of trade or imposes any material anticompetitive burden on trading or clearing, unless necessary or appropriate to achieve the purposes of the CEA.



B. Conflicts of Interest for SDs and MSPs

- § 731: Overview of Conflict of Interest Requirements: SDs and MSPs must create appropriate “informational partitions” between:
 - Persons researching or analyzing the price or market for any commodity or Swap; and
 - Persons whose involvement in pricing, trading or clearing might potentially bias the judgment or supervision of research personnel.
- CFTC Rulemaking: *Proposed Rules on Conflicts of Interest for Swap Dealers and Major Swap Participants* (75 Fed. Reg. 71,391) (11/23/2010)



B. Conflicts of Interest for SDs and MSPs (cont.)

- Influence on Research:
 - The proposed rules place restrictions on non-research personnel influencing the content of research reports prepared by research analysts employed by an SD or MSP.
 - SDs and MSPs are also prohibited from considering a research analyst's contributions to the trading or clearing business when setting the research analyst's compensation.

B. Conflicts of Interest for SDs and MSPs (cont.)

- Influence on Research (cont.):
 - SDs and MSPs cannot offer favorable research, or threaten to change research, for existing or prospective counterparties in exchange for business or compensation.
 - SDs and MSPs cannot retaliate against any research analyst who produces a research report that may adversely impact certain of the firm's business activities.

B. Conflicts of Interest for SDs and MSPs (cont.)

- Conflicts in Clearing Activities: MSPs and SDs—
 - Cannot interfere with or attempt to influence decisions related to the provision of clearing or the acceptance of clearing customers; and
 - Must maintain appropriate partitions between business trading personnel and affiliated clearing member personnel.

B. Conflicts of Interest for SDs and MSPs (cont.)

- Disclosure of Personal Conflicts of Interest:
 - SDs and MSPs are required to disclose whether a research analyst maintains a financial interest in any derivative of a type that the research analyst follows, and the general nature of the financial interest.
 - Research analysts must make the same disclosure when making public appearances.

B. Conflicts of Interest for SDs and MSPs (cont.)

- **PRACTICE NOTES:**
 - Conflict of interest rules potentially create shifts in an SD's or MSP's organizational structure, so it is important to determine whether such rules apply.
 - To the extent conflict of interest rules apply, an SD or MSP may incur costs to train its personnel or create appropriate “informational partitions” in its data systems.



C. Designation of Chief Compliance Officer

- CCO and Annual Report Requirements: Section 731 of the Act adds a new Section 4s(k) of the CEA—
 - SDs and MSPs must designate a Chief Compliance Officer (“CCO”) to establish and administer compliance policies and resolve conflicts of interest within the organization; and
 - The CCO must prepare, sign, and certify an annual report that contains a description of the registrant’s compliance with (i) the CEA, (ii) CFTC regulations, and (iii) each policy of the registrant.



C. Designation of Chief Compliance Officer (cont.)

- CFTC Rulemaking: *Proposed Rule on Designation of Chief Compliance Officer and Preparation of Annual Compliance Report* (75 Fed. Reg. 70,881) (11/19/2010)
- Qualifications of a CCO:
 - Appropriate background and skills to fulfill his/her responsibilities.
 - Cannot have been disqualified from registration under the CEA.
 - As a principal of the MSP or SD, CCO would submit a fingerprint card and undergo a background investigation by the NFA.
 - CCO is not required to register with the CFTC.



C. Designation of Chief Compliance Officer (cont.)

- General Duties of a CCO:
 - Establish compliance policies;
 - Resolve conflicts of interest;
 - Ensure compliance of the MSP or SD with internal policies, CEA requirements, and CFTC regulations;
 - Identify noncompliance issues and establish procedures for the remediation of such noncompliance issues
- All of the above duties (with the exception of ensuring compliance) must be undertaken in consultation with the board of directors or senior officer of the MSP or SD.



C. Designation of Chief Compliance Officer (cont.)

- Annual Reporting Requirement: The CCO is required to submit an annual report to the CFTC that contains, among other things:
 - A description of the registrant's compliance with the CEA, CFTC regulations, and the registrant's own compliance policies;
 - An assessment of the effectiveness of the registrant's policies;
 - A discussion of areas for improvement;
 - A description of the resources set aside for compliance; and
 - A description of any non-compliance issues identified and addressed.



D. Business Conduct Standards

- § 731: Business Conduct Standards:
 - The Act adds a new Section 4s(h) to the CEA which gives the CFTC authority to impose business conduct standards for SDs and MSPs dealing with counterparties generally and “special entities” (such as federal agencies, municipalities and other governmental entities).
- CFTC Rulemaking: *Proposed Rules Regarding Business Conduct Standards for Swap Dealers and Major Swap Participants Dealing with Counterparties* (75 Fed. Reg. 80,638) (12/22/2010)



D. Business Conduct Standards (cont.)

- Prohibition on Fraud and Abusive Practices: The Proposed Rules generally prohibit—
 - Fraudulent, deceptive, and manipulative acts or practices;
 - Treating counterparty information in a non-confidential manner; and
 - Trading ahead and front running of counterparty Swap transactions.



D. Business Conduct Standards (cont.)

- General Duties Owed to All Counterparties:
 - Verification of a counterparty's eligibility to transact in Swaps markets;
 - Disclosure of:
 - Material risks, such that:
 - For high-risk complex bilateral Swaps, there is a duty to provide scenario analyses; and
 - For bilateral Swaps not available for trading on a DCM or SEF, counterparty can “opt-in” to obtain scenario analyses;
 - Material characteristics of a Swap; and
 - Material incentives and/or conflicts of interest in the Swap.



D. Business Conduct Standards (cont.)

- General Duties Owed to Counterparties (cont.):
 - The daily mid-market value of uncleared Swaps;
 - Notification of a counterparty's right (i) to clear a Swap that is exempt from mandatory clearing, and (ii) select the DCO;
 - Ensure communications to a counterparty are fair and balanced;
 - Ensure Swap recommendations are suitable for the counterparty;
 - For Swaps available for trading on a DCM or SEF, a duty to execute orders on terms that are reasonably related to the best terms available.



D. Business Conduct Standards (cont.)

- Advisors to Special Entities: If an SD acts as an advisor to a Special Entity, it owes a duty to act in the “best interests” of the Special Entity.
- “Acts as an advisor” includes recommending a Swap or a trading strategy involving a Swap.
- The phrase does not include information that is general transaction, financial or market information, or Swap terms provided in response to the Special Entity’s competitive bid request.



D. Business Conduct Standards (cont.)

- MSPs and SDs as Counterparties to Special Entities: MSPs and SDs must have a reasonable basis to believe that a Special Entity counterparty has a “representative” that meets the following criteria:
 - Sufficiently knowledgeable to evaluate the transaction and risks;
 - Not subject to statutory disqualification;
 - Independent of the SD or MSP;
 - Acts in the best interests of the Special Entity;
 - Makes appropriate and timely disclosures to the Special Entity;
 - Evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and appropriateness of the Swap;



D. Business Conduct Standards (cont.)

- MSPs and SDs as Counterparties to Special Entities: MSPs and SDs must have a reasonable basis to believe that a Special Entity counterparty has a “representative” that meets the following criteria (cont.):
 - In the case of a Special Entity that is an employee benefit plan subject to ERISA, is a fiduciary as defined in Section 3 of ERISA; and
 - In the case of a Special Entity that is a municipal entity, is subject to restrictions on certain political contributions to certain public officials of the municipal entity (unless the representative is in-house).



D. Business Conduct Standards (cont.)

- MSPs and SDs as Counterparties to Special Entities (cont.):
 - MSPs and SDs also must disclose to the Special Entity the capacity in which the MSP or SD is acting (*i.e.*, whether a fiduciary relationship exists).
 - **PRACTICE NOTE:**
 - Industry participants should keep such disclosure and representative requirements in mind when drafting energy trading agreements with Special Entities, such as municipalities.



D. Business Conduct Standards (cont.)

- Means of Compliance with Standards: SDs and MSPs can—
 - Reasonably rely, absent red flags, on representations of counterparties to meet due diligence obligations;
 - Make disclosures by any reliable means agreed to by the counterparty;
 - Make generic disclosures to counterparties in a standard format; and
 - Include representations and disclosures in a master agreement between the parties, and deem them renewed with each subsequent Swap.
 - NOTE: Such clarification is useful when drafting the ISDA, EEI or other trading agreements.



D. Business Conduct Standards (cont.)

- Exceptions and Clarifications: The CFTC's business conduct standards do *not* apply in certain circumstances, such as when—
 - A transaction is initiated by a counterparty on a DCM or SEF, such that the SD or MSP does not know the identity of the counterparty; or
 - The counterparty to a Swap is another SD or MSP (or a security-based SD or MSP).



E. Confirmation and Portfolio Requirements

- § 731: General Confirmation Requirement: The Act requires SDs and MSPs to conform to CFTC standards that “relate to the timely and accurate confirmation, processing, netting, documentation and valuation of all Swaps”.
- CFTC Rulemaking: *Proposed Rule on Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants* (75 Fed. Reg. 81,519) (12/28/2010)

E. Confirmation and Portfolio Requirements (cont.)

- Proposed Confirmation Rules:
 - Swaps Between Two SDs or MSPs:
 - The parties must execute a confirmation for the Swap on the same calendar day as execution.
 - Specific times for obtaining a Swap confirmation (*e.g.*, immediately upon execution or later in the day) would vary depending on whether the transaction is executed and/or processed electronically.



E. Confirmation and Portfolio Requirements (cont.)

- Proposed Confirmation Rules (cont.):
 - *Swaps Between an SD/MSP and a Non-SD/MSP:*
 - SD or MSP must send an acknowledgement of the Swap transaction to the counterparty on the same day as execution;
 - SD or MSP must have procedures in place to confirm the Swap transaction (i) on the same calendar day as execution (for Financial Entities), and (ii) on the next business day for all other counterparties.
 - Such procedures must include an obligation to furnish to, or receive from, its prospective counterparty a draft acknowledgement specifying the terms of the Swap transaction prior to execution (other than pricing and terms to be definitively agreed upon at execution).



E. Confirmation and Portfolio Requirements (cont.)

- When Do Confirmation/Acknowledgment Procedures Apply?
 - All events that would result in (i) a new Swap, or (ii) a change in the terms of a Swap.
 - *E.g.*, execution, termination prior to the scheduled maturity date, assignment, novation, exchange, transfer, amendment, conveyance, or extinguishing of rights or obligations.
- Contents: Confirmations and acknowledgments must include all of the terms of the Swap transaction.
- Recordkeeping: An SD or MSP must create and maintain certain records of the required acknowledgements and confirmations.

E. Confirmation and Portfolio Requirements (cont.)

- Portfolio Reconciliation Requirements:
 - SDs and MSPs must reconcile Swap portfolios with other SDs and MSPs on a daily, weekly or quarterly basis, depending on the size of the particular Swap.
 - Any discrepancies in material Swap terms must be resolved immediately.
 - Any discrepancies in valuation generally must be resolved within one business day.
 - If a portfolio involves a Non-SD or Non-MSP, the SD/MSP must establish written policies to perform reconciliations with varying frequency (based on portfolio size).

E. Confirmation and Portfolio Requirements (cont.)

- Portfolio Compression Requirements:
 - SDs and MSPs must participate in multilateral portfolio compression exercises (i) required by CFTC regulation or order, or (ii) offered by a DCO, a self-regulatory organization, or a self-regulatory association of which the SD or MSP is a member.
 - SDs and MSPs must (i) terminate bilaterally all fully-offsetting Swaps between them within one day, and (ii) engage annually in bilateral portfolio compression exercises with counterparties that are also SDs or MSPs.
 - For Swaps with Non-SDs or Non-MSPs, SDs and MSPs must have written procedures for periodically terminating offsetting Swaps and engaging in portfolio compression exercises.



VI. Margin Requirements and Position Limits

- Topics for Discussion:
 - A. Capital and Margin Requirements
 - B. Position Limits

A. Capital and Margin Requirements

- § 731: General Rule: SDs and MSPs must meet minimum capital requirements and minimum initial and variation margin requirements as the CFTC shall determined by rule or regulation.
- Capital Requirements:
 - The CFTC shall take into account any risks associated with other types of Swaps the SD/MSP is engaged in and other activities of the SD/MSP that are not otherwise subject to regulation.
 - The capital requirements established by the CFTC shall (i) help ensure the safety and soundness of the SD or MSP; and (ii) be appropriate for the risk associated with the uncleared Swaps held by the SD or MSP.

A. Capital and Margin Requirements (cont.)

- Margin Requirements:
 - The CFTC shall permit the use of non-cash collateral, if appropriate to (i) preserve the financial integrity of markets trading Swaps; and (ii) preserve the stability of the U.S. financial system.
- **PRACTICE NOTES:**
 - It does not seem clear what specific types of collateral the CFTC will permit to satisfy margin requirements. Letters of Credit? First liens?
 - If collateral exchanged under a trading agreement is not a type permitted by the CFTC, trading counterparties may need to amend their collateral obligations.



B. Position Limits

- § 737: General Rule on Position Limits:
 - With respect to physical commodities (other than certain commodities excluded by the CFTC), the CFTC shall establish limits on the amount of positions, *other than bona fide hedge positions*, that may be held by any person with respect to (i) contracts of sale for future delivery, or (ii) options on the contracts or commodities traded on or subject to the rules of a DCM.
 - Similarly, the CFTC shall also set position limits on “economically equivalent” swaps, other than “bona fide hedge positions”.
 - “*Economically Equivalent Swaps*”: Swaps that are economically equivalent to contracts of sale for future delivery or to options on contracts or commodities traded on or subject to the rules of a DCM).

B. Position Limits (cont.)

- § 737: General Rule on Position Limits (cont.):
 - The CFTC shall establish limits on the *aggregate number or amount of positions* in contracts based upon the *same underlying commodity* that may be held by any person (including any group or class of traders) *for each month* across:
 - Contracts listed by DCMs;
 - For agreements, contracts or transactions that settle against any price of 1 or more contracts listed for trading on a registered entity, contracts traded on a foreign board of trade that provides members or other participants located in the U.S. with direct access to its electronic trading and order matching system; and
 - Swap contracts that perform or affect a significant price discovery function



B. Position Limits (cont.)

- CFTC Rulemaking: *Proposed Regulations Regarding Position Reports for Physical Commodity Swaps* (75 Fed. Reg. 67,258) (11/2/2010)
 - Daily position reports must be submitted by clearing organizations, their members and SDs for Swaps that are “economically equivalent” to regulated futures and options contracts in exempt and agricultural commodities (*e.g.*, crude oil, coal, and natural gas).
 - A Swap is “economically equivalent” to a futures contract either (i) because the floating price of the Swap refers to a covered futures contract settlement price; or (ii) the Swap is priced on the same commodity delivered at the same location.

B. Position Limits (cont.)

- CFTC Rulemaking: *Proposed Regulations Regarding Position Reports for Physical Commodity Swaps* (75 Fed. Reg. 67,258) (11/2/2010) (cont.)
 - The information collected by the CFTC on “economically equivalent” swaps will be used by the CFTC to monitor aggregate position limits for Swaps based upon the same underlying commodity.
 - The CFTC rule becomes ineffective upon the CFTC’s issuance of an order finding that SDRs are capable of processing positional data in a manner that would enable the CFTC to set and enforce aggregate position limits.

B. Position Limits (cont.)

- CFTC Rulemaking: *Proposed Regulations Regarding Position Limits for Derivatives* (Approved by CFTC on January 13, 2011) (to be published in the Federal Register)
 - Sets position limits in physical commodity futures contracts and Swaps that are “economically equivalent” to such contracts, as mandated by the Act.
 - *E.g.*, crude oil, natural gas, heating oil, gasoline, etc.
- Implementation of Position Limits: Two Phases—
 - Initial Transitional Phase: Limits on spot-month contracts only, based on deliverable supply determined by DCMs;
 - Second Phase: Limits expanded to single-month and all-month-combined contracts, based on CFTC’s determination of deliverable supply and position limits outside of the spot-month.

B. Position Limits (cont.)

- Implementation of Position Limits (cont.):
 - Spot-month position limits set at 25% of deliverable supply for a given commodity, with a conditional spot-month limit of 5 times that amount for entities with positions exclusively in cash-settled contracts.
 - Non-spot-month position limit for each referenced contract to be set using a 10, 2.5 % formula:
 - 10% of open interest in that contract below the first 25,000 contracts, and
 - 2.5 % of open interest in the contract at or above 25,000 contracts.



B. Position Limits (cont.)

- Exemption: Bona Fide Hedging Transactions: A “bona fide hedging” transaction or position is one that either:
 - (i) Meets all of the following criteria:
 - Represents a substitute for transactions made or positions taken in a physical marketing channel;
 - Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and
 - Arises from the potential change in the value of (i) assets that a person owns, produces, manufactures, processes or merchandises (or anticipates doing such activities); (ii) liabilities that a person owns or anticipates incurring; or (iii) services that a person provides, purchases or anticipates providing or purchasing; OR



B. Position Limits (cont.)

- Exemption: Bona Fide Hedging Transactions (cont.):
 - (ii) The hedging transaction or position reduces risks attendant to a position resulting from a Swap that:
 - Was executed with a counterparty for which the transaction qualifies as a “bona fide hedging transaction”; or
 - Otherwise meets the requirements set forth in subsection (i) above.
- Exemption: Positions Prior to Effective Date:
 - Another exemption exists for positions established in good faith prior to the effective date of specific limits adopted pursuant to the proposed regulations.



B. Position Limits (cont.)

- Visibility Reporting:
 - In addition to setting position limits, the Proposed Rule establishes proposed “visibility levels” and associated reporting requirements for holders of physical commodity derivative positions.
 - Such reporting will provide the CFTC with information to make future adjustments to the position limit framework.

B. Position Limits (cont.)

- Who Will Be Affected by Position Limits? The CFTC anticipates that, on an annual basis, position limits will affect:
 - *For spot-month position limits:*
 - 70 traders in agricultural contracts;
 - 6 traders in base metals contracts;
 - 8 traders in precious metals contracts; and
 - 40 traders in energy contracts.
 - *For all-months combined and single-month position limits:*
 - 80 traders in agricultural contracts;
 - 25 traders in base metal contracts;
 - 25 traders in precious metals contracts; and
 - 20 traders in energy contracts.



B. Position Limits (cont.)

- Position “Points” Directive: Even before position limits are finalized, Chairman Gensler has directed CFTC staff to monitor position “points”:
 - If a trader has a position that is above a level of 10% of open interest in a futures contract and 2.5% of open interest in an option on a futures contract:
 - CFTC will collect information on the positions;
 - Staff has special “call authority” to monitor position levels; and
 - CFTC has monthly closed surveillance meetings and can make appropriate recommendations based on the position levels.
 - NOTE: Positions “points” are at same levels as position limits in the Proposed Rule—but the Rule itself is not yet enforceable.



B. Position Limits (cont.)

- Problems with Position Limits and the CFTC’s Actions?
 - “Serious problems” with Chairman Gensler’s position “points” directive before the Proposed Rule is enforceable (*Statement of Commissioner Scott D. O’Malia, Prior to Notice of Proposed Rulemaking (Jan. 13, 2011)*):
 - Directive only applies to futures markets—the only market in which the CFTC currently has reliable data;
 - Fails to consider whether monitored traders will later be subject to a “bona fide hedging” exemption; and
 - Directive is not part of the Proposed Rule itself, and thus there is no notice or comment period prior to implementation.

B. Position Limits (cont.)

- Problems with Position Limits and the CFTC's Actions?
 - Proposed Rule on position limits was only approved so that Commissioners may now receive public comments.
 - *Opening Statement of Commissioner Michael Dunn, Public Meeting on Proposed Rule (Jan. 13, 2011)*
 - The Proposed Rule was approved by four Commissioners—only 1 voted against the measure.
 - Undetermined how the CFTC will respond to public comments.
 - At least one Commissioner has said the position “points” directive may open the door to legal challenges (*Commissioner Scott D. O’Malia, Prior to Notice of Proposed Rulemaking (Jan. 13, 2011)*).



Conclusion: Dodd-Frank Act

- The most important determination is whether a party qualifies as an MSP or SD.
 - Most CFTC obligations hinge on that analysis.
- If you qualify as an MSP or SD, you will be subject to numerous, detailed requirements that significantly impact your business operations and trading agreements:
 - Mandatory clearing
 - Capital and margin requirements
 - Reporting and recordkeeping requirements
 - Business conduct standards and operational requirements
 - Position limits



Should you be focused on the
Dodd-Frank Act?



YES!!!