

Corporate & Financial Weekly Digest

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CFTC Publishes Seventh Series of Dodd-Frank Rules

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The Commodity Futures Trading Commission has published its seventh series of rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act. The latest round of CFTC rules and rule proposals relates to an “end user” exception from otherwise-mandatory swap clearing requirements; governance requirements for derivatives clearing organizations (DCOs), designated contract markets (DCMs) and swap execution facilities (SEFs); the reporting of swaps entered into after the enactment of Dodd-Frank but before the effectiveness of the CFTC’s swap recordkeeping rules; and business conduct standards for swap dealers (SDs) and major swap participants (MSPs).

- *“End-User” Swap Clearing Exemption:* The CFTC has proposed to implement the “end-user” clearing exemption set out in Section 2(h)(7) of the Commodity Exchange Act (CEA), as amended by the Dodd-Frank Act. As amended, the CEA provides an elective exemption from mandatory clearing for swaps where (1) at least one party to the swap is not a “financial entity” (a category which includes SDs, MSPs, commodity pools, private funds and banking entities, among others), (2) such party is using the swap to hedge or mitigate commercial risk, and (3) a notice is provided regarding how such party meets its financial obligations associated with entering into non-cleared swaps. Under the CFTC’s proposed rule, “hedging or mitigating commercial risk” would be defined in substantially the same manner as in the CFTC’s recently proposed definition of “major swap participant,” and would include “bona fide hedging” positions under CFTC rules, positions that qualify for hedging treatment under Financial Accounting Standards Board standards, and certain other positions that reduce commercial risks of the end-user. Swap positions that are held for speculative, investing or trading purposes, or which are used to hedge or mitigate the risk of another swap position (unless such other swap falls within the definition of hedging or mitigating commercial risk) would not be eligible for the exemption. Under the CFTC proposal, the required notice must be provided through a swap data repository (if available) and include information about the methods used by the end-user to mitigate counterparty credit risk and certain other information.

The CFTC has requested comment as to whether certain small banks, savings associations, farm credit system institutions and credit unions should be allowed to rely upon the end-user exemption, as well as other aspects of the proposed rule.

- *Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets and Swap Execution Facilities:* The CFTC is also proposing new rules to implement the governance standards for DCOs, DCMs and SEFs required by the CEA as amended by Dodd-Frank Act Sections 725(c), 735(b) and 733. The proposed rules include requirements that:
 1. each publicly traded DCM evaluate the breadth and cultural diversity of its board of directors;
 2. non-member market participants agree to become subject to the jurisdiction of the DCM;
 3. each DCO report to the CFTC when its board rejects a recommendation or supersedes an action of its risk management committee, and each DCM or SEF report to the CFTC when its board rejects a recommendation or supersedes an action of its regulatory oversight committee or the membership or participation committee;
 4. each DCO establish governance arrangements that permit the consideration of the views of owners and participants, and each DCM institute a process for considering the opinions of market participants with respect to (i) the functioning of an existing market and (ii) new rules or rule amendments;
 5. each DCO or DCM specify and enforce minimum fitness standards for its members, directors, members of any disciplinary panel or disciplinary committee, certain affiliates, and any persons with direct access to a DCM, and annually verify to the CFTC compliance with such standards;
 6. the regulatory oversight committee of each DCM or SEF prepare an annual report assessing its regulatory program and make such report available to the CFTC;
 7. each DCO, DCM or SEF implement a regulatory program to identify and address existing and potential conflicts of interest;
 8. each DCO, DCM or SEF establish limits on the use or disclosure of non-public information by owners, members of the board, members of any committee, officers or other employees;
 9. each DCO, DCM or SEF make certain information on governance arrangements available to the public and relevant authorities, including summaries of significant decisions;
 10. each DCO, DCM or SEF submit to the CFTC information concerning its board members, including the basis on which a board member is determined to qualify as a “public director” or a “customer representative”; and
 11. each DCO, DCM or SEF make publicly available certain governance information, including information relating to access, membership and disciplinary procedures.

Additionally, the CFTC is now proposing to require each DCO to have 10% customer representation on its board. The CFTC formerly proposed requiring each DCO to have customer representation only on a DCO’s risk management committee (or a risk management subcommittee), but has since revised its position. In connection with the new proposal, the CFTC is seeking comment on the implications of requiring 10% customer representation on a DCO’s board and whether the requirement would be more appropriate at the risk management committee level.

- *Reporting Certain Post-Enactment Swap Transactions:* Section 723 of the Dodd-Frank Act requires that “transition swaps” be reported to the CFTC or a registered swap data

repository within certain time periods. The CFTC has published an interim final rule (1) identifying a reporting timetable in accordance with the foregoing requirement, (2) defining the term “transition swap”, and (3) establishing requirements for the preservation of information by counterparties to transition swaps. A “transition swap” is a swap executed on or after the date of enactment of the Dodd-Frank Act and prior to the effective date of the CFTC’s swap data recordkeeping and reporting rules. The interim final rule provides that transition swap data must be reported within 90 days after July 15, 2011, “or such other time after entering into the swap as the [CFTC] may prescribe by rule.” In accordance with this reporting requirement, the interim final rule requires counterparties to a transition swap to retain all documents and information relating to the terms of the transaction. The interim final rule is effective immediately and will remain in effect until the CFTC implements final recordkeeping and reporting requirements. The CFTC is requesting comment on various issues related to the requirements of Section 723 of the Dodd-Frank Act and the interim final rule. Comments are due within 30 days from the date the release is published in the *Federal Register*.

- *Business Conduct Standards for Swap Dealers and Major Swap Participants:* The Dodd-Frank Act provides the CFTC with authority to implement business conduct standards for SDs and MSPs in their dealings with counterparties, including “Special Entities” (i.e., any federal agency, state, state agency, county, city, municipality or other political subdivision of a state, employee benefits plan or government plan under the Employee Retirement Income Security Act of 1974 or endowment). The CFTC has proposed rules that would impose certain requirements and duties on SDs and MSPs with respect to counterparties, including the following:
 1. SDs and MSPs would be prohibited from engaging in “fraudulent, deceptive and manipulative acts and practices,” including front running or trading ahead of counterparty swap transactions, and are required to handle counterparty data in a confidential manner (similar to rules applicable to futures commission merchants and introducing brokers).
 2. SDs and MSPs would have a number of duties to counterparties including, among other things, the duty to verify that the counterparty meets the eligibility standards for an eligible contract participant in order to enter into swaps transactions (unless the SD or MSP does not know the identity of the counterparty), and to disclose material risks (including sufficient information to enable a counterparty to assess such risks), incentives, conflicts of interest (e.g., compensation the SD or MSP receives from any third party in connection with the swap) and characteristics (e.g., material terms of the swap). SDs and MSPs would also have a duty to communicate in a fair and balanced manner with counterparties, based on “principles of fair dealing and good faith.” Further, the CFTC is proposing to impose an “institutional suitability obligation” on SDs and MSPs, “modeled, in part, on existing obligations for banks and broker-dealers dealing with institutional clients,” triggered anytime an SD or MSP makes a tailored recommendation to a counterparty regarding a particular swap transaction or trading strategy.
 3. Any SD or MSP that “acts as an advisor to a Special Entity” (including recommending a swap transaction or trading strategy involving swaps, but not including providing swap

terms in response to a competitive bid request by a Special Entity) must act in the “best interests” of such Special Entity.

4. Before acting as a counterparty to a Special Entity, SDs and MSPs must have a reasonable basis to believe that such Special Entity has an independent representative that, among other things, is sufficiently knowledgeable to evaluate the transaction and risks, and acts in the best interests of the Special Entity.
5. SDs and MSPs that have made political contributions to officials of a “municipal entity” are prohibited from entering into swaps with such municipal entity. This proposal is intended to create consistency with “pay-to-play” prohibitions under federal securities laws.

The proposal provides that, in connection with these requirements and duties, SDs and MSPs would be permitted to reasonably rely on counterparties’ representations. Any such representations and any disclosure obligations of SDs and MSPs could be set forth in a master agreement between the parties and deemed renewed at the time of each swap transaction entered into by the parties. The CFTC has requested comment on numerous issues, both general and specific, in connection with these rule proposals.

Unless otherwise noted, the comment periods for these proposals will expire 60 days from the dates of their respective publications in the *Federal Register*. Information regarding all of the CFTC proposals, including the text of the CFTC releases, fact sheets and Q&As, can be found [here](#).

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