

## CFTC Proposes Key Rulemakings that Complete the “Mosaic” of Proposed Rules to Implement Title VII of the Dodd-Frank Act

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The Commodity Futures Trading Commission (“CFTC”) held an open meeting yesterday to issue several key proposed rulemakings that, together with the CFTC’s other proposed rulemakings to date, complete the so-called “mosaic” of CFTC proposed rules to implement Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).<sup>1</sup> Topics addressed by yesterday’s proposed rules include definitions for the terms “swap”, “security-based swap” and “security-based swap agreement” (collectively the “product definitions”) as well as capital requirements for swap dealers and major swap participants, segregation of cleared swaps customer collateral and conforming amendments to existing CFTC regulations. The Securities and Exchange Commission (“SEC”) also held an open meeting yesterday to consider the proposed rule on the product definitions, which is a joint proposed rule by the CFTC and the SEC.

The texts of the proposed rules will not be published in the Federal Register for several days. The discussion below is based on comments made by CFTC Commissioners and staff during yesterday’s open meeting as well as CFTC [fact sheets and Q&As](#) and an SEC [press release](#).

### Product Definitions

The CFTC and SEC jointly proposed rules that further define the terms “swap”, “security-based swap” and “security-based swap agreement” contained in Section 721 of the Dodd-Frank Act.

The proposed rules are comprehensive: they clarify which products will fall within the definitions listed above, and which products will not. In general, the proposed rules classify as swaps those derivatives transactions that market participants already consider swaps, namely those that are listed in the definition of a swap contained in Section 721(a) of the Dodd-Frank Act, but clarify which products will not be picked up by the definition’s catch-all provision that has generated considerable concern.<sup>2</sup> In addition, the proposed rules clarify that foreign exchange (“FX”) forwards and FX swaps will be swaps until such time they are exempted, if ever, from the swap definition by the Secretary of the U.S. Treasury and also make clear that other FX products, including FX options and currency swaps, cannot be exempted and are swaps.<sup>3</sup> The proposed rules clarify that the following are not swaps:

- Insurance products meeting specific criteria that are issued by U.S. state-regulated insurers, as well as specific products issued by such insurers including surety bonds, life insurance, health

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<sup>1</sup> With one exception: the CFTC has yet to propose rules pertaining to the Volcker rule.

<sup>2</sup> §721(a)(21) of the Dodd-Frank Act (The term “swap” means any agreement, contract or transaction “that provides for any purchase, sale, payment or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of any event or contingency associated with a potential financial, economic or commercial consequence.”).

<sup>3</sup> See Sutherland’s [Legal Alert](#) for more information. In discussing the proposed rules, CFTC staff noted that such exempted FX transactions will still be subject to certain requirements applicable to swaps, including swap data recordkeeping and reporting obligations.

insurance, long-term care insurance, title insurance, property and casualty insurance and annuity products the income on which is subject to tax treatment under Section 72 of the Internal Revenue Code;

- Certain commercial contracts, including purchase and sale agreements, mortgage commitments and fixed or variable-rate commercial loans issued by non-banks;
- Forward contracts for non-financial commodities that are intended to be physically-settled.<sup>4</sup>
- Consumer transactions (e.g., transactions entered into by natural persons for personal, family or household purposes).

The proposed rules also address the distinction between “swaps” that will be regulated by the CFTC and “security-based swaps” that will be regulated by the SEC. The proposed rules provide a regulatory framework for “mixed swaps” and “security-based swap agreements” over which both the CFTC and the SEC have jurisdiction. In cases where it remains unclear how a transaction should be classified, the proposed rules contain a process for requesting guidance from the CFTC and the SEC with respect to whether a product is a swap, security-based swap or mixed swap. The proposed rules also contain broad anti-evasion provisions.

The proposed rules also establish recordkeeping and reporting requirements for security-based swap agreements.

## Legal Segregation of Cleared Swaps Customer Collateral

The second proposed rule issued by the CFTC yesterday relates to collateral segregation for cleared swaps. The CFTC first addressed this issue in an Advanced Notice of Proposed Rulemaking (“ANPR”) published last December.<sup>5</sup> The proposed rule calls for the complete legal (but not physical) segregation of cleared swaps customer collateral. Under this model a derivatives clearing organization (“DCO”) may hold all of the collateral posted by all of a futures commission merchant’s (“FCM”) customers in one account separate from the other accounts of the FCM; the DCO must keep records of the collateral on a customer-by-customer basis. If an FCM defaults to the DCO because of a default by one of the FCM’s customers, the DCO would have recourse to the collateral posted by that defaulting customer (as well as the resources of the FCM itself) but not the collateral posted by the FCM’s other non-defaulting customers.

The CFTC’s selection of the legal segregation model was based on public comments received in response to its ANPR. However, the CFTC is still evaluating the costs and benefits of this model and has included questions about two other models in the preamble to the proposed rule. These models include: (1) adopting the model currently used in the futures space (*i.e.*, customer collateral is co-mingled in an omnibus customer account and therefore available to the DCO if the customer’s FCM defaults because of

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<sup>4</sup> The CFTC’s “Brent Interpretation” regarding “booked-out” transactions also would apply to the forward exclusion from the swap definition for nonfinancial commodities. Market participants that regularly make or take delivery of the referenced commodity in the ordinary course of their business, where the book-out transactions are effectuated through a subsequent, separately-negotiated agreement, would qualify for the forward exclusion from the swap definition.

<sup>5</sup> See Sutherland’s [End-User Legal Alert](#) for a discussion about the ANPR. The ANPR itself is available [here](#).

a default of one of the FCM's other customers), and (2) a modified version of the current futures model known as the "recourse model", which would require DCOs to modify their default waterfall so that the DCO may only use non-defaulting customers' collateral to remedy an FCM default after the DCO utilizes its own resources and the resources of other non-defaulting FCMs. At the meeting, CFTC Chairman Gensler and the CFTC's General Counsel, Dan Berkovitz, indicated that the final rule could adopt the proposed complete legal segregation model or one of the other models discussed in the preamble to the proposed rule as a "logical outgrowth of what is being considered," and that the selection of any of those alternatives would comply with the Administrative Procedure Act and would not necessarily require a new notice and comment period. The CFTC also believes that it could issue a final rule allowing each DCO to choose from alternative models approved by the CFTC.

While the CFTC's proposed rule on collateral segregation for cleared swaps is a "victory" for those market participants who advocated for this model, the issues left open in the preamble to the proposed rule create a great deal of legal uncertainty. It will be impossible for market participants to fully evaluate the risks to which they will be exposed in connection with their cleared swaps until the CFTC issues its final rules. The CFTC announced yesterday that it will hold a roundtable sometime in the next two months for DCOs, FCMs and swap market participants to voice their concerns and discuss the costs and benefits associated with the various collateral segregation models.

## Capital Requirements for Swap Dealers and Major Swap Participants

The CFTC's proposed rules to establish capital requirements for swap dealers and major swap participants apply only to those entities that are not regulated by one of the "Prudential Regulators" (*i.e.*, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration or the Federal Housing Finance Agency).<sup>6</sup> The proposed rules divide such swap dealers and major swap participants into three categories: (1) swap dealers and major swap participants that are FCMs; (2) swap dealers and major swap participants that are not FCMs but that are non-bank subsidiaries of U.S. bank holding companies; and (3) other swap dealers and major swap participants.

Under the proposed rules, swap dealers and major swap participants that are also FCMs would be subject to the CFTC's existing capital requirements for FCMs as well as several additional rules, including a \$20 million minimum capital requirement. Non-bank subsidiaries of U.S. bank holding companies would be required to comply with the capital requirements that are applicable to their U.S. bank holding company; such entities must also hold at least \$20 million of Tier 1 capital. Other swap dealers and major swap participants would be required to maintain tangible net equity of at least \$20 million, plus additional amounts for market risk and over-the-counter derivatives risk. Real property and other non-liquid assets may be used to meet the required tangible net equity levels. A swap dealer or major swap participant may apply to the CFTC to use internal models for capital calculations.

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<sup>6</sup> The Prudential Regulators issued proposed capital requirements, which merely cross-reference other capital requirements set by those regulators, on April 12, 2011 (See Sutherland's [Legal Alert](#) for more information). The CFTC's proposal imposes new capital requirements for those swap dealers and major swap participants that are not regulated by the Prudential Regulators.

The proposed capital rules would also require swap dealers and major swap participants that do not receive margin from their end-user counterparties to hold additional capital to account for their uncollateralized exposure to such counterparties.

***At yesterday's open meeting the CFTC stated that the deadline for public comments in response to the proposed capital requirements rule will be coterminous with the CFTC's previously proposed margin requirements for uncleared swaps.*** The margin requirements for uncleared swaps notice of proposed rulemaking ("NOPR") was published in today's Federal Register and indicates that the deadline for receipt of public comments is June 27, 2011. Accordingly, market participants should expect that the deadline for receipt of public comments in response to both rules will be the later of June 27 or the due date specified in the capital requirements NOPR that will be published in the Federal Register in the coming days.

### Amendments to Adapt Certain CFTC Regulations to the Dodd-Frank Act

The Dodd-Frank Act amended numerous provisions of the Commodity Exchange Act to give the CFTC authority to regulate swaps. The final set of proposed rules issued at yesterday's CFTC meeting make conforming changes to adapt the CFTC's existing regulations to the Dodd-Frank Act. For the most part, the proposed rules are not substantive; they make technical changes to the CFTC's existing regulations pertaining to FCMs, execution platforms and recordkeeping and reporting obligations. CFTC Commissioners and staff noted that some of the proposed rules may be more substantive than ministerial, however, and they urged market participants to review the rules carefully to determine what, if any, adverse effects they may have on the market.

Now that its "mosaic" of proposed rules to implement Title VII of the Dodd-Frank Act is complete,<sup>7</sup> the CFTC will begin considering the order and manner in which final rules will be issued, made effective and implemented. To this end, the CFTC will hold, jointly with the SEC, public roundtables on Monday and Tuesday of next week (May 2nd and 3rd) to address these topics – the tentative agenda for the roundtables is available [here](#). The CFTC is also accepting public comments on these topics via its [Web site](#). Additionally, at the end of yesterday's meeting, the CFTC voted to re-open or extend the comment periods for several of its previously proposed rules. These comment periods will be re-opened or extended for 30 days. Details about the proposed rules that will be subject to the additional comment periods will be published in the Federal Register.



*If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

|                     |              |  |
|---------------------|--------------|--|
| James M. Cain       | 202.383.0180 | <a href="mailto:james.cain@sutherland.com">james.cain@sutherland.com</a>             |
| Paul B. Turner      | 713.470.6105 | <a href="mailto:paul.turner@sutherland.com">paul.turner@sutherland.com</a>           |
| Catherine M. Krupka | 202.383.0248 | <a href="mailto:catherine.krupka@sutherland.com">catherine.krupka@sutherland.com</a> |
| Warren N. Davis     | 202.383.0133 | <a href="mailto:warren.davis@sutherland.com">warren.davis@sutherland.com</a>         |

<sup>7</sup> See note 1 above.

William H. Hope II  
Mark D. Sherrill  
Ann M. Battle  
Michael W. Brooks  
Doyle Campbell  
Meltem F. Kodaman  
Raymond A. Ramirez

404.853.8103  
202.383.0360  
202.383.0842  
202.383.0863  
212.389.5073  
202.383.0674  
202.383.0868

[william.hope@sutherland.com](mailto:william.hope@sutherland.com)  
[mark.sherrill@sutherland.com](mailto:mark.sherrill@sutherland.com)  
[ann.battle@sutherland.com](mailto:ann.battle@sutherland.com)  
[michael.brooks@sutherland.com](mailto:michael.brooks@sutherland.com)  
[doyle.campbell@sutherland.com](mailto:doyle.campbell@sutherland.com)  
[meltem.kodaman@sutherland.com](mailto:meltem.kodaman@sutherland.com)  
[ray.ramirez@sutherland.com](mailto:ray.ramirez@sutherland.com)