

CFTC Proposes Rules to Phase in Compliance with Dodd-Frank's New Derivatives Requirements and Releases Tentative Rulemaking Schedule

September 19, 2011

On September 8, 2011, the CFTC held an open meeting to consider two proposed rules under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The proposed rules address implementation schedules for compliance with the Dodd-Frank Act's (1) swap clearing and platform execution requirements; and (2) swap documentation and margining requirements for uncleared swaps. Copies of proposed rules are available [here](#). The CFTC also released a tentative outline for issuance of final versions of the majority of its rulemakings under Title VII of the Dodd-Frank Act. A copy of the tentative implementation schedule is available [here](#).

In his opening remarks at the CFTC's open meeting, Chairman Gensler provided further insight on the CFTC's final rulemaking schedule. A copy of his remarks are available [here](#). According to Chairman Gensler, the CFTC intends to take a focused and thoughtful approach that is "not against a clock" in promulgating the remaining final rules required by Title VII of the Dodd-Frank Act. Chairman Gensler also announced that he has directed the CFTC Staff to draft appropriately tailored recommendations for further exemptive relief from self-effectuating provisions of the Dodd-Frank Act similar to the temporary exemptive relief that was granted by the CFTC on July 14, 2011 (the CFTC Temporary Relief Order).¹

The CFTC Temporary Relief Order did not apply to provisions of Title VII of the Dodd-Frank Act that required a final rulemaking by the CFTC (or other regulator) because such provisions did not self-effectuate on July 16, 2011. These so-called "Category I" provisions, which are listed in the Appendix to the CFTC Temporary Relief Order, include mandatory clearing and platform execution, capital and margin requirements, swap documentation requirements, recordkeeping requirements and reporting requirements. These provisions take effect *no less than* 60 days after final versions of the applicable rulemakings implementing the provisions are published in the Federal Register. There is no outer limit on when such provisions and corresponding rulemakings must take effect and therefore the CFTC has a considerable amount of discretion to establish lengthy and/or phased-in effective dates for the provisions. The CFTC is proposing to exercise such discretion with its recently proposed rules, which establish phased-in compliance schedules for compliance with Title VII's clearing, trade execution, trading documentation and margin requirements.

¹ A copy of Sutherland's Legal Alert addressing the CFTC's July 14, 2011 temporary relief is available [here](#). The first part of the final order provided temporary relief from provisions of the CEA which referenced terms such as "swap," "swap dealer," "major swap participant" and "eligible contract participant," which the Dodd-Frank Act required to be further defined, until the earlier of (1) the effective date of the applicable final rule further defining the relevant term; or (2) December 31, 2011. The second part of the final order provided temporary relief from certain provisions of the CEA which would have applied after July 16, 2011 to certain agreements, contracts and transactions in commodities previously exempt or excluded from the CEA prior to the Dodd-Frank Act until the earlier of (1) the CFTC's repeal or withdrawal of Part 35 of the CFTC's existing regulations which provided an exemption for swap agreements; or (2) December 31, 2011.

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Clearing Requirements Under Section 2(h)(1) of the CEA

Under 2(h)(1)(A) of the CEA, as amended by Section 723(a)(3) of the Dodd-Frank Act, it is unlawful for any person to engage in a swap that is required to be cleared unless that swap is submitted for clearing to a derivatives clearing organization (a DCO) that is either registered or exempt from the Dodd-Frank Act. Under Section 2(h)(2) of the CEA, as amended by Section 723(a)(3) of the Dodd-Frank Act, the CFTC must determine whether a swap is required to be cleared based on either a CFTC-initiated review or submission from a DCO of each swap, or any group, category, type or class of swaps that the DCO plans to accept for clearing.

According to the preamble to the CFTC's proposed rule regarding implementation schedules for clearing and trade execution requirements, before market participants could be required to comply with mandatory clearing, the CFTC must first (1) adopt final rules related to the end-user exception² to mandatory clearing under Section 2(h)(7) of the CEA (the End-User Exception); (2) finalize joint rules with the SEC defining "swap," "swap dealer" and "major swap participant"; and (3) adopt final rules relating to the protection of margin posted in connection with cleared swaps. The CFTC will make mandatory clearing decisions based on the schedule set forth in its final rule regarding the process for review of swaps for mandatory clearing (the CFTC Clearing Rule).

Trade Execution Requirement Under Section 2(h)(8) of the CEA

Under Section 2(h)(8) of the CEA, as amended by Section 723(a)(8) of the Dodd-Frank Act, all the execution of all clearable swaps must occur on a designated contract market (DCM) or a swap execution facility (SEF) unless no DCM or SEF "makes the swap available for trade" or the swap is subject to the End-User Exception.

According to the preamble to the CFTC's proposed rule regarding clearing and trade execution requirements, the CFTC must (1) finalize the three rules referenced above in connection with mandatory clearing; and (2) adopt all final rules related to DCMs and SEFs before market participants could be required to comply with Title VII's mandatory platform execution requirements. Once the CFTC has completed these required rulemakings, platform execution requirements would be triggered upon the later of (1) the applicable deadline established under the proposed compliance schedule for the associated clearing mandate; or (2) 30 days after the swap is made available for trading on either a SEF or DCM.

The CFTC's proposed rules would not prohibit any type of market participant from voluntarily complying with clearing or trade execution requirements sooner than the applicable compliance deadline.

Clearing and Trade Execution Proposed Implementation Schedule

In addition to the foregoing, the CFTC has proposed a three-phase implementation plan that divides market participants entering into swaps subject to clearing or trade execution requirements into three categories. Each time the CFTC determines that a swap or group, category, type or class of swaps, must

² The CFTC's proposed end-user exception allows for an elective exemption for swaps that are otherwise subject to mandatory clearing if one party to the swap (1) is not a financial entity; (2) is using the swap to hedge or mitigate commercial risk; and (3) notifies the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps. See End-User Exception to Mandatory Clearing of Swaps, 75 FR 80747, Dec. 23, 2010.

be cleared, it will have the discretion to phase in such requirements based on the classification of the counterparties executing the swap.

Phase 1/Category 1 Entity

- Category 1 Entities include swap dealers (SDs), security-based swap dealers, major swap participants (MSPs), major security-based swap participants and active funds. The proposed definition of “active funds,” which is based on Section 2(h)(7)(C) of the CEA and Section 402 of the Dodd-Frank Act, would include any private fund as defined in Section 202(a) of the Investment Advisors Act of 1940, that is not a third-party subaccount and that executes 20 or more swaps per month based on a monthly average over the 12 months preceding the CFTC issuing a mandatory clearing determination under Section 2(h)(2) of the CEA. The CFTC believes this proposed swap volume threshold is appropriate because these private funds would likely have sufficient resources to comply with clearing and trade execution requirements earlier than other types of market participants and have sufficient market experience to contribute meaningfully to the “buy-side” perspective as industry standards are developed.
- Category 1 Entities would be required to comply with mandatory clearing requirements within 90 days of the CFTC’s issuance of such requirements.³
- Trade execution would be required for a swap as of the later of (1) the time at which the swap is required to be cleared; or (2) 30 days after the swap is made available for trading.

Phase 2/Category 2 Entity

- Category 2 Entities include commodity pools, private funds as defined by Section 202(a) of the Investment Advisors Act of 1940 (other than active funds), employee benefits plans as defined in Sections 3(3) and 3(32) of ERISA of 1974 as well as persons predominately engaged in activities that are in the business of banking, or activities of a financial nature as defined in 4(k) of the Bank Holding Company Act of 1956, but not a third-party subaccount.
- Category 2 Entities would be required to comply with mandatory clearing requirements within 180 days of the CFTC’s issuance of such requirements.
- Trade execution would be required for a swap as of the later of (1) the time at which the swap is required to be cleared; or (2) 30 days after the swap is made available for trading.

Phase 3/Category 3 Entities

- All other market participants, including third-party subaccounts whose swap transactions are not otherwise excepted from mandatory clearing requirements must comply with the clearing requirement within 270 days after the CFTC issues the clearing requirement. Third-party subaccounts will have 270 days as the CFTC expects these portfolios will have hundreds or even thousands of accounts to bring into compliance, which would involve each managed account receiving specific approval by the beneficial owner of the account to execute documentation necessary for executing, confirming, margining or clearing swaps. For example, if an investment

³ Which, pursuant to the CFTC Clearing Rule, would take effect on the latest of (1) December 25, 2011 (90 days after September 26, 2011, the effective date of the CFTC Clearing Rule); (2) 90 days after the date on which a DCO begins to clear such a swap; or (3) such other date agreed to between the CFTC and the applicable DCO.

manager from firm X manages the assets of pension fund Y, and does so in a separate account that requires approval of pension Y to execute necessary documentation, then the account would have 270 days for compliance. However, if pension fund Y manages its own assets, pension fund Y would be a Category 2 entity and have only 180 days to comply with the mandatory clearing and trade execution requirements. However, market participants are permitted to come into compliance more quickly than the 270-day limit.

- The CFTC has proposed giving third-party subaccounts the most time for compliance since they will likely require the greatest amount of time for documentation, coordination and management.

The CFTC anticipates that it will exercise its authority to trigger the proposed compliance schedules each time it requires clearing for a new group, category, type or class of swaps. Note, however, that as DCOs begin clearing swaps within the same group, category, type or class of swaps, such swaps will be subject to mandatory clearing without phase-in.

Swap Trading Relationship Documentation under Section 4s(i)(2) of the CEA

On January 13, 2011 (as required by Section 731 of the Dodd-Frank Act which added Section 4s(i)(2) to the CEA), the CFTC proposed trading documentation rules requiring SDs and MSPs to enter into swap trading relationship documentation with their counterparties (the Swap Documentation Rules).⁴ Pursuant to the CFTC's recently proposed rule, before SDs and MSPs must comply with the new swap trading documentation requirements, the CFTC must adopt final versions of (1) the Swap Documentation Rules; (2) rules further defining "swap," "swap dealer" and "major swap participant"; (3) rules regarding the protection of collateral for uncleared swaps; (4) rules regarding confirmation of swap transactions; and (5) rules regarding SD and MSP registration, including procedures for provisional registration (collectively, the Required Documentation Rulemakings).

Margin Requirements under Section 4s(e) of the CEA

Pursuant to Section 4s(e)(2)(B) of the CEA (as amended by the Dodd-Frank Act), SDs and MSPs must establish both initial and variation margin requirements for all of their swaps that are not cleared by a registered DCO. On April 28, 2011, the CFTC proposed margin requirements for uncleared swaps entered into by non-bank SDs and MSPs (the CFTC Uncleared Swaps Margin Rules).⁵

⁴Specifically, under the proposed rule, SDs and MSPs must establish, maintain and enforce written policies and procedures designed to ensure that they agree in writing with their respective counterparties to all terms of their swap trading relationship and have executed all required agreements. Specifically, written agreements between SDs and MSPs and their counterparties must include terms relating to payment obligations, netting of payments, events of default or other termination events, netting of obligations upon termination, transfer of rights and obligations, governing law, valuation methodologies, dispute resolution procedures and swap transaction confirmations. In addition, this swap trading relationship documentation must include credit support agreements along with initial and variation margin terms, eligible collateral terms investment and rehypothecation terms and collateral segregation provisions (which may also include tri-party agreements with independent third-party custodians). SD and MSPs would also be required to include a provision in the trading documentation regarding the parties' understanding of the new orderly liquidation as authorized under Title II of the Dodd-Frank Act and the Federal Deposit Insurance Act. See Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715 (February 8, 2011).

⁵Also on April 28, 2011, the "Prudential Regulators" (*i.e.*, the Federal Deposit Insurance Corporation, the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Housing Finance Agency and the Farm Credit Administration), proposed margin requirements for SDs and MSPs that are not banks. The CFTC's recently proposed rules on implementation timing that are the subject of this alert would not apply to the prudential regulators' requirements.

Trading Documentation and Margin Requirement Implementation Schedule

Similar to the CFTC's implementation schedule for clearing and trading execution requirements, the CFTC has proposed a phase-in compliance schedule for the Swap Documentation Rules and the CFTC Uncleared Swaps Margin Rules based on the type of market participant entering into the swaps subject to such requirements.

Category 1 Entities

- Category 1 Entities include SDs, security-based swap dealers, MSPs and major security-based swap participants that will be required to register with the CFTC or the SEC and active funds. The term "active funds" is defined in the same manner as it is defined in the proposed rules for clearing and trade execution requirements.
- For transactions with a Category 1 Entity, SDs and MSPs must comply with the Swap Documentation Rules within 90 days of each publication in the Federal Register of the Required Documentation Rulemakings and must comply with the CFTC Uncleared Swaps Margin Rules within 90 days of the publication in the Federal Register of such rules.

Category 2 Entities

- Category 2 Entities include commodity pools, private funds as defined by Section 202(a) of the Investment Advisors Act of 1940 (other than an active fund), employee benefit plans identified in Sections 3(3) and 3(32) of ERISA of 1974 as well as persons predominately engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956, provided that the entity is not a third-party subaccount.
- For transactions with a Category 2 Entity, SDs and MSPs must comply with the Swap Documentation Rules within 180 days of each publication in the Federal Register of the Required Documentation Rulemakings and must comply with the CFTC Uncleared Swaps Margin Rules within 180 days of the publication in the Federal Register of such rules.

Category 3 Entities

- Category 3 Entities include Category 2 Entities whose positions are held as third-party subaccounts.
- For transactions with a Category 3 Entity, SDs and MSPs must comply with the Swap Documentation Rules within 270 days of each publication in the Federal Register of the Required Documentation Rulemakings and must comply with the CFTC Uncleared Swaps Margin Rules within 270 days of the publication in the Federal Register of such rules.

Category 4 Entities

- Category 4 Entities include any person not included in Categories 1, 2, or 3.
- For transactions with a Category 3 Entity, SDs and MSPs must comply with the Swap Documentation Rules within 270 days of each publication in the Federal Register of the

Required Documentation Rulemakings and must comply with the CFTC Uncleared Swaps Margin Rules within 270 days of the publication in the Federal Register of such rules.

CFTC Seeks Public Comment

The CFTC is seeking public input on both proposed rules discussed herein. Comments will be due 45 days after the date on which the proposed rules are 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.

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