

CFTC Issues Two Additional Proposed Rules Under the Dodd-Frank Act at Its First Open Meeting of 2011

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The Commodity Futures Trading Commission (CFTC) issued two proposed rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) at its first open meeting of the new year on Thursday, January 13, 2011. The first proposed rule addresses position limits for certain commodity futures contracts and “economically equivalent derivatives.” This proposed rule is substantively the same as the proposed rule on position limits that the CFTC considered but did not adopt at its last open meeting on December 16, 2010. The second proposed rule addresses swap documentation requirements for swap dealers and major swap participants and is a continuation of a proposed rule on swap confirmation, portfolio reconciliation and portfolio compression requirements for swap dealers and major swap participants that the CFTC issued at its December 16, 2010, open meeting.

The text of these proposed rules have not yet been published in the Federal Register. This discussion is based on statements made at the January 13, 2011, and December 16, 2010, open meetings and the Fact Sheets and Q&As made available by the CFTC.

Position Limits

The Dodd-Frank Act expands the authority of the CFTC to impose position limits on 28 exchange traded commodities (including metals, agricultural commodities and energy commodities) and “economically equivalent” derivatives. The proposed rule adopted by the CFTC on Thursday would establish such position limits in two phases.

Phase One. The first phase would essentially give the CFTC the authority to monitor and enforce the spot-month position limits currently imposed by the exchanges. These limits would apply during the last days of the spot month, in the same way that the exchange spot-month position limits currently function. Also akin to the position limits currently imposed by the exchanges, these limits would be set at 25% of deliverable supply for physically settled contracts (as determined by the exchanges) and five times that level for cash-settled positions. Bona fide hedging transactions (as defined under the Dodd-Frank Act) will not be included in determining whether any entity has exceeded position limits.

Phase Two. During the second phase, the CFTC will also impose separate limits outside of the spot month. These limits will be set using a proposed percentages of open interests formula that we understand is the percentage formula used to establish the current position limits for agricultural commodities. Position limits will be imposed on the aggregate amount of an entity’s on- and off-exchange positions (to the extent that such off-exchange swaps are “economically equivalent” to exchange contracts). Separate limits will also be imposed for exchange traded contracts and “economically equivalent” off-exchange swap transactions. Based on the discussion at Thursday’s meeting, it is unclear when the second phase position limits will actually take effect. It was clear that the CFTC does not have the data it needs to set such limits at this time, particularly with respect to off-exchange “commercially equivalent” swaps, and that the Commissioners and staff are uncertain about when they will have such information. It is also unclear whether the actual limits derived from the proposed formula will be imposed pursuant to a subsequent series of CFTC orders or otherwise.

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Position Visibility Reporting Regime. To facilitate the CFTC's information-gathering efforts, the proposed rule adopted on Thursday contains a "position visibility reporting regime" that will require the exchanges to report information about large traders to the CFTC staff. Based on statements made by the CFTC staff, we understand that the CFTC will request additional information from traders whose exchange-traded positions rise above 10% of the open interest for the first 25,000 contracts and 2.5% thereafter. Such additional information would include information about the entity's "economically equivalent" swap transactions and the entity's business purposes for holding such positions. The staff will then present this information to the Commissioners on a monthly basis. While the CFTC does have "emergency authority" under Section 8a(9) of the Commodity Exchange Act to "take such action as in the Commission's judgment is necessary to maintain or restore orderly trading in or liquidation of any futures contract," the CFTC's general counsel stated at Thursday's meeting that a violation of the visibility levels would not alone be sufficient for the CFTC to take action against a trader.

The CFTC has published a [Fact Sheet](#) and a [Q&A](#) for its proposed rule on Position Limits.

Additional Documentation Requirements for Swap Dealers and Major Swap Participants

The second proposed rule adopted by the CFTC at Thursday's meeting addressed additional documentation requirements for swap dealers and major swap participants. This proposed rule is an extension of the proposed rule on Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants that the CFTC adopted at its open meeting on December 16, 2010, and which is available [here](#). While the proposed rule specifically applies to swap dealers and major swap participants, it impacts the documentation that swap dealers and major swap participants will use to enter into transactions with all market participants, including end-users.

Policies and Procedures. Swap dealers and major swap participants will be required to establish policies and procedures to ensure that all terms of their swap transactions are properly documented before or contemporaneously with entering into such transactions. The policies must also require an annual audit of a swap dealer's or major swap participant's swap documentation.

Valuation Methodology and Dispute Resolution. Written documentation for uncleared swaps entered into by swap dealers and major swap participants must include methods, procedures, rules and inputs for valuing such swaps at all times during the life of the swaps. Such valuation methodology must be independently verifiable by a third party or the CFTC and must include alternative inputs (e.g., alternative indices) to be used in the event that one or more inputs are unavailable or fail. The CFTC's proposed rule on Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants required that any valuation disputes between a swap dealer/major swap participant and another swap dealer/major swap participant be resolved within one business day and any valuation disputes between swap dealers/major swap participants and counterparties that are not swap dealers or major swap participants be resolved in a "timely fashion." The proposed rule adopted by the CFTC yesterday imposed the additional requirement that if any valuation disputes are not resolved within such time periods, the disputes must be reported to the CFTC and to senior management of the swap dealer or major swap participant.

Specific Documentation Requirements. The proposed rule sets forth certain additional information that swap dealers and major swap participants must include in their written documentation for uncleared

swaps. This information includes payment obligations, events of default, transfer rights, governing law, initial margin requirements, variation margin requirements and any custodial arrangements. With respect to cleared swap transactions, the proposed rule requires swap dealers and major swap participants to create a record of each of their swap transactions that conforms to the template established by the rules of the applicable Derivatives Clearing Organization (DCO). The terms of this record must also confirm to all of the terms of the cleared trade that will be established once the DCO accepts the swap and must state that the transaction will be extinguished if and when it is accepted for clearing. This requirement will apply to the documentation for swaps that are executed bilaterally and then submitted for clearing and to whatever documentation is used for trades that are executed on a Designated Contract Market or Swap Execution Facility and then submitted for clearing.

Documentation for End-User Exception From Mandatory Clearing. The proposed rule requires that swap dealers and major swap participants obtain supporting documentation from any of their counterparties who utilize the end-user exception from mandatory clearing. Such documentation must be sufficient to provide the swap dealer or major swap participant with a reasonable basis to believe that its counterparty qualifies for the clearing exemption and must provide the swap dealer or major swap participant with the information it needs to report the swap to a Swap Data Repository.

The CFTC has published a [Fact Sheet](#) and a [Q&A](#) for its proposed rule on Additional Reporting Requirements for Swap Dealers and Major Swap Participants.



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