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A legal update from Dechert's Financial Services Group

CFTC Adopts Customer Property Segregation and Other Swap Regulations; Proposes Volcker Rule

The Commodity Futures Trading Commission (CFTC) on January 11, 2011 finalized three important rules and proposed one additional rule as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).[1] These rules address the treatment of collateral posted for cleared swaps, the registration and business conduct requirements applicable to swap dealers and major swap participants, and the CFTC-specific provisions of the "Volcker Rule." Various aspects of these final and proposed rules will have direct and indirect implications for mutual funds, private funds, separately managed accounts, and other users participating in the commodity markets.

Protection of Cleared Swap Customer Contracts and Collateral

The CFTC adopted rules that impose requirements on futures commission merchants (FCMs) and derivatives clearing organizations (DCOs) to protect cleared swap customer contracts and related collateral. These rules are also intended to enhance the portability of cleared swaps in the event of an FCM's bankruptcy.

Title VII of the Dodd-Frank Act requires that most standard swaps be cleared and exchange traded. Title VII also requires that each party to a cleared swap post collateral with the FCM through which the party is entering the trade in order to secure its obligations under the swap. In turn, the FCM is required to be a clearing member of, and to submit the swap for clearing and execution with, a DCO. In accordance with the rules of the DCO, the FCM is required to post with the DCO all or part of the collateral the FCM receives from the swap party (*i.e.*, its customer). In connection with these requirements, the Dodd-Frank Act amended the Commodity Exchange Act, as amended (CEA) to add a new Section 4d(f) that imposes certain requirements relating to cleared swaps and associated collateral. Each FCM and DCO must (i) hold cleared swap customer collateral in an account that is segregated from the property belonging to the FCM or DCO, and (ii) not use the collateral of one cleared swap customer to cover the obligations of another cleared swap customer or the obligations of the FCM or DCO. These requirements are analogous to, but not the same as, those set forth under Section 4d(a)(2) of the CEA and the CFTC regulations thereunder relating to FCM treatment of customer funds and property applicable to exchange-traded commodity futures and options contracts.[2]

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1 Performance of Registration Functions by National Futures Association With Respect To Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2709 (Jan. 19, 2012). At the time of publication of this *DechertOnPoint*, the other two final rules discussed have not yet been published in the Federal Register. This update is based on copies of the rules, *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister011112d.pdf, and does not reflect any technical amendments that may be made to the other two final rules before official publication.

2 *See* CFTC Rules 1.3(k), (gg), (hh), and (jj), 1.20-1.30, 1.32, 1.68, and 30.7.

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The Dodd-Frank Act also revised the U.S. Bankruptcy Code (Bankruptcy Code) to include cleared swaps in its definition of "commodity contracts" to provide certain protections for customer funds and property and the related swaps in the event of an FCM or DCO insolvency.

To implement the foregoing requirements, the CFTC adopted new Part 22 of its regulations. The CFTC had considered several methods of segregation of customer collateral before adopting a model referred to as the "Complete Legal Segregation" model or the "LSOC Model" (*i.e.,* "legal segregation with operational commingling"). The CFTC also considered adopting a method of segregation referred to as the "Futures and Options Model," among others.

LSOC Model

The rules adopted the LSOC model, which provides for complete legal segregation of customer funds and property relating to cleared swaps on the books of the FCM or DCO, but permit the operational commingling of such funds and property with that of other cleared swap customers of the FCM or DCO in a single "omnibus" account, referred to as the Complete Legal Segregation model or the LSOC Model. An FCM is required to provide the relevant DCO with information at least daily regarding the identity of the FCM's underlying customers whose positions are held in the account, the portfolio positions held by each customer, and the margin associated with those positions. In the event of a default by both a clearing member FCM and one or more of the clearing member's cleared swap customers due to a cleared swap customer loss, the DCO would have recourse solely against the collateral of the defaulting cleared swap customers of that clearing member FCM as well as the assets of such FCM itself. A DCO would not have recourse to the collateral posted by non-defaulting cleared swap customers to meet the FCM's obligations to the DCO.

The LSOC Model has been the subject of intense interest for the buy-side market. Although central clearing of swaps and posting of associated collateral is intended to reduce systemic risk, it will not entirely de-risk the cleared swaps markets. In fact, the use of a central clearing organization creates a potential single point of failure. Posting collateral to a central counterparty makes that collateral available to an FCM and DCO in the case of a single counterparty's default. Buy-side participants are concerned that contagion from one party's default, including an FCM's, could spread and jeopardize all participants' cleared swaps collateral as a result of fraud, negligence, or operational mishap resulting in a shortfall in required collateral. The LSOC model also mutualizes risk to the extent that, if an FCM were to fail and there is a shortfall in required col-lateral, all cleared swap customers could face losses on a pro rata basis. Proportionate sharing of loss is mitigated in the over-the-counter (OTC) market when mutual funds, certain private funds, and other participants post collateral to third-party segregated/custody accounts.[3]

Although the rules permit the commingling of cleared swap customer property, the LSOC model provides for segregation of FCM-cleared customer property from non-cleared customer property. The CFTC is actively considering seeking notice and comment on a proposal to improve individual protection of customer assets for both cleared swaps and exchange-traded futures and options.

Physical Segregation Model

The CFTC considered requiring full physical segregation (Physical Segregation Model) for cleared swap customer collateral. Under this model, in the ordinary course of business (prior to a double default, *i.e.,* default by both the FCM and its customer), each FCM and DCO would segregate, on its books and records, the cleared swaps for each individual customer and associated collateral. The Physical Segregation Model is different from the LSOC Model in that each FCM and DCO would maintain separate individual accounts for the relevant collateral. As a result, the FCM would ensure that the DCO does not use the collateral of one cleared swap customer to support the obligations of another customer, by making certain that the DCO does not mistakenly transfer collateral from the account belonging to one such customer to the account belonging to another. The CFTC did not adopt this model due to the potential increased costs involved.

Futures and Options Model

The CFTC also considered replicating the segregation requirements currently applicable to the exchange-traded commodity futures and options markets (Futures Model), which provide for the separate accounting for and segregation of associated customer funds and property from the FCM's property but permit

[3] The safety customers gain through the use of third-party accounts introduces additional costs into the cleared markets and potentially raises swap prices for customers.

the operational commingling of funds and property of all customers. Prior to a double default, each FCM would identify, on its books and records, the cleared swaps that an FCM intermediates on an "omnibus" basis. Following a double default, the DCO would be permitted to access the collateral of the non-defaulting cleared swap customers before applying its own capital or the guaranty fund contributions of the non-defaulting FCM members.

Investment of Customer Collateral

New Part 22 also provides that cleared swap collateral may only be invested in accordance with the limitations imposed on FCMs' investment of futures and options customers' property under CFTC Rule 1.25, as recently amended.[4]

Application of Financial and Segregation Interpretation No. 10 to Cleared Swaps

The CFTC clarified that its 2005 Amendment to Financial and Segregation Interpretation No. 10 on the Treatment of Funds Deposited in Safekeeping Accounts (Segregation Interpretation 10-1)[5] does not apply to cleared swaps. As a result, cleared swap customer collateral may be deposited in a third-party safekeeping account instead of posting collateral directly to the FCM without the FCM being deemed in violation of new Section 4d(f) of the CEA.

If an FCM allows the use of a third-party account, then that FCM must comply with all of the conditions for such accounts set forth in Segregation Interpretation 10-1 as originally issued in 1984.[6] In addition, although the use of third-party accounts is not prohibited, such collateral constitutes customer property within the meaning of the Bankruptcy Code. Therefore, even if a customer holds collateral in a third-party account, the customer remains subject to the risk mutualization concerns discussed above.

FCM Bankruptcy Rules

The CFTC amended Part 190 of its regulations to implement the Dodd-Frank Act's changes to the Bankruptcy Code to, among other things (i) include swaps cleared with a DCO as customer contracts for commodity brokers, and (ii) include swap execution facilities (SEFs) as a category of trading venue. The CFTC also updated Part 190 to reflect certain swap market practices (*e.g.*, providing for auctions of swap portfolios in the event of a commodity broker insolvency).

Registration of Swap Dealers and Major Swap Participants

Title VII of the Dodd-Frank Act added to the CEA new Section 4s, which requires "swap dealers" and "major swap participants"[7] to register with the CFTC and to meet specific requirements with regard to capital and margin, reporting and recordkeeping, maintenance of daily trading records, business conduct standards, documentation standards, trading duties, designation of a chief compliance officer, and segregation of customer funds (Section 4s Requirements). The final rules establish the process for the registration of swap dealers and major swap participants (Swap Registrants). The rules also require that Swap Registrants become and remain members of the National Futures Association (NFA),[8] the independent, self-regulatory organization for the U.S. futures industry that processes the registrations for commodity market participants subject to CFTC jurisdiction and develops rules, programs, and services to protect investors from fraudulent commodity market activities. The CFTC has

4 Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 76 Fed. Reg. 78776 (Dec. 19, 2011) (to be codified at 17 C.F.R. pts 1 and 30). *See also DechertOnPoint: CFTC Finalizes Amendments to Customer Funds Rule and Addresses Other Dodd-Frank Act Business*, available at http://www.dechert.com/files/Publication/059507e6-0b86-430a-8637-02a44ec59009/Presentation/PublicationAttachment/d6c3af24-32ce-48a5-be60-1afd16cdd384/FS%20%2329%20-%2012-11%20-%20CFTC%20Finalizes%20Amendments.pdf (December 2011).

5 Amendment of Interpretation, 70 Fed. Reg. 24768, May 11, 2005 (Notice). The underlying Financial and Segregation Interpretation No. 10 was issued on May 23, 1984, and can be found at Comm. Fut. L. Rep. (CCH) ¶ 7120.

6 These conditions include limitations regarding the titling and location of the third-party safekeeping account, and requirements concerning the FCM's rights to promptly liquidate positions and access collateral.

7 As of now, the CFTC has not fully defined these terms. These terms will be defined in future CFTC rules.

8 Registration of Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2613 (Jan. 19, 2012) (to be codified at 17 C.F.R. pts. 1, 3, 23 and 170) [Registration Rules].

estimated that approximately 10 market participants would qualify as major swap participants.[9] This is the registration category into which a mutual fund, private fund, or separately managed account would be categorized if it met one of the major swap participant tests.

To apply for registration, a Swap Registrant must file with the NFA a Form 7-R and, for each of its principals, a Form 8-R and a fingerprint card. Additionally, the Swap Registrant must demonstrate compliance with each Section 4s Requirement then applicable to it, and must demonstrate compliance with any other Section 4s Requirements if and as they become applicable. Concurrent with the adoption of the Registration Rules, the CFTC is delegating to the NFA the authority to perform the full range of registration functions for Swap Registrants, including the processing of applications for registration and confirmation of initial compliance with applicable Section 4s Requirements.

The Registration Rules also prohibit any Swap Registrant from permitting any person associated with it who is subject to a CEA "statutory disqualification"[10] to effect swaps on its behalf if the Swap Registrant knows, or in the exercise of reasonable care should know, of the statutory disqualification. The Registration Rules provide a limited exception to this prohibition for any associated person of a Swap Registrant, who has been duly listed as a principal or registered as an associated person of another registrant (*e.g.*, an FCM, commodity pool operator, or commodity trading advisor (CTA)). Note that, to the extent that a mutual fund, private fund or separately managed account qualifies as a major swap participant, each such entity would be subject to the Registration Rules.

Business Conduct Standards for Swap Registrants

The Dodd-Frank Act added new Section 4s(h) to the CEA to require the CFTC to promulgate rules establishing certain due diligence and disclosure obligations for Swap Registrants when dealing with counterparties in general and when dealing with "Special Entities" in particular (Business Conduct Rules).[11]

General duties and requirements

Among the most important provisions of the Business Conduct Rules is the general anti-fraud prohibition of Swap Registrant conduct that is fraudulent, deceptive, or manipulative. The Business Conduct Rules provide an affirmative defense to non-scienter violations by a Swap Registrant that can establish that it (i) did not act intentionally or recklessly with respect to the alleged fraud or deceit, and (ii) complied in good faith with written policies reasonably designed to prevent such abusive activity. In addition to the proscription against fraud, the Business Conduct Rules also prohibit a Swap Registrant from disclosing any confidential information provided by, or for the benefit of, any swap counterparty. Similarly, Swap Registrants are barred from appropriating such confidential information if doing so would have a material adverse impact on its counterparty.

The Business Conduct Rules further require Swap Registrants to verify that their counterparties are "eligible contract participants" before offering or entering into a swap transaction with those counterparties. Likewise, Swap Registrants must verify whether a counterparty is, or may choose to be, a Special Entity. In meeting these requirements, a Swap Registrant may rely on the written representations of its counterparty.[12] Swap Registrants will have a reasonable basis to

9 Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 75 Fed. Reg. 80174, 80205 (Dec. 21, 2010).

10 The Registration Rules provide that a statutory disqualification, for purposes of this prohibition, refers to a statutory disqualification under Section 8a(2) or 8a(3) of the CEA, and clarify that a "person associated with a swap dealer or major swap participant" refers to an "associated person" as defined by CFTC regulations.

11 A Special Entity is: (i) a Federal Agency; (ii) a State, State agency, city, county, municipality, or other political subdivision of a State; (iii) an employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974 as amended (ERISA); (iv) a governmental plan as defined in Section 3 of ERISA; (v) an endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986 as amended; or (vi) an employee benefit plan, as defined in Section 3 of ERISA, not otherwise defined as a Special Entity that elects to be treated as a Special Entity by notifying a Swap Registrant of its election prior to entering into a swap with such Swap Registrant.

12 A Swap Registrant may rely on the written representations of a counterparty provided that the Swap Registrant does not possess any information that would cause a reasonable person to question the veracity of the representation.

rely on those representations when a counterparty specifies in its representations the rules or laws establishing it as an eligible contract participant or Special Entity. Swap Registrants are under no obligation to verify a counterparty's status when a transaction is initiated on a designated contract market (DCM) or SEF and the Swap Registrant does not know the identity of the counterparty prior to the transaction.

Additionally, the Business Conduct Rules obligate Swap Registrants to disclose material information concerning a swap transaction to any counterparty that is not also a Swap Registrant. This disclosure must be made in a "reasonably sufficient time" before entering into the swap, and must provide the counterparty with enough information to assess: (i) the material risks of the swap; (ii) the material characteristics of the swap; (iii) the material incentives for the Swap Registrant to enter into the swap; and (iv) any conflicts of interest the swap may create for the Swap Registrant. Moreover, when entering into swaps that have not been made available to trade by a DCM or SEF, a swap dealer must inform its counterparty that the counterparty has the right to receive a scenario analysis. This analysis must provide the counterparty with the ability to assess its potential loss under the swap. As with the Special Entity verification rules discussed above, these rules do not apply to a transaction initiated on a DCM or SEF where the Swap Registrant does not know the identity of its counterparty before executing the transaction. Furthermore, for *uncleared* swaps, a Swap Registrant must provide its counterparty with a daily mid-market mark at the close of business each day during the life of the swap.

A Swap Registrant also will be required to provide certain clearing disclosures to its counterparty. For cleared swaps, these disclosures include notifying the counterparty of its right to select the DCO for clearing. For swaps that are not required to be cleared, a Swap Registrant must also inform its counterparty that it has the right to require the swap to be cleared and the right to select the DCO for clearance. The Business Conduct Rules provide that these disclosures, and any other communications made by a Swap Registrant to its counterparty, must be made in a fair and balanced manner in accordance with the principles of good faith and fair dealing.

Finally, the Business Conduct Rules implement an institutional suitability requirement for swaps recommended by swap dealers. Under this requirement, when a swap dealer recommends a swap to any counterparty that is not a Swap Registrant, the swap dealer must use reasonable diligence to understand the risks and rewards of the recommended swap for the counterparty. Furthermore, a swap dealer must have a reasonable basis to believe that the recommended swap is suitable for the counterparty. A swap dealer will meet this standard when its counterparty represents that it will rely on its independent judgment to evaluate a recommended transaction, and the swap dealer discloses to its counterparty that the swap dealer is not undertaking to analyze the suitability of the swap for that counterparty.

Considerations for Special Entities

The Business Conduct Rules provide additional duties and requirements for Swap Registrants that enter into swaps with Special Entities. For example, a swap dealer that recommends swaps or swap-based trading strategies to a Special Entity may be deemed to be acting as an advisor to that Special Entity if the swap or swap-based strategy is adapted to the individual needs or attributes of the Special Entity. Should a swap dealer be deemed an advisor, the swap dealer would be required to make a reasonable determination that entering into any recommended swap or swap-based strategy would be in the best interests of the Special Entity. [13] Notably, compliance with these obligations

[13] The rules provide safe harbors to enable swap dealers to avoid this designation. If the counterparty is an ERISA plan, a swap dealer will not be deemed to be acting as its advisor if the Special Entity represents in writing that: (i) it has an ERISA fiduciary that is responsible for its representation in swap transactions; (ii) it will act in accordance with policies it has designed to guarantee that any recommendation made by a swap dealer is evaluated by that fiduciary before executing the transaction; and (iii) any recommendation made by a swap dealer will be evaluated by that fiduciary before entering into a transaction. Additionally, for the swap dealer to benefit from this safe harbor, the Special Entity's fiduciary must also represent in writing that it will not rely on the swap dealer's recommendation regarding any swap or swap-based trading strategy designed for the Special Entity.

For all Special Entities, including ERISA plans, the swap dealer will not be subject to the "best interests" duty if: (i) the swap dealer "does not express an opinion as to whether the Special Entity should enter into a recommended swap or [swap-based] trading strategy;" (ii) the swap dealer discloses that it is not acting in the Special Entity's best interests; and (iii) the Special Entity represents in writing that it will not rely on the swap dealer's recommendations.

At the meeting in which these rules were adopted, CFTC staff made clear that, if a swap dealer did not want to be held to the "best interests" standard, the swap dealer could say in its relationship documentation that its communications will not express an opinion about whether the

does not subject a Swap Registrant to the ERISA fiduciary requirements[14] or the CFTC's CTA requirements.[15]

Moreover, before entering into a swap transaction with a non-ERISA Special Entity, a Swap Registrant must have a reasonable basis to believe that the Special Entity has an independent representative that operates in its best interests, with sufficient capacity to understand the risks of the transaction, and is not disqualified from registration under the CEA, in addition to certain other requirements. Under this provision, a Swap Registrant will have a reasonable basis to reach such a conclusion if the non-ERISA Special Entity explains that it has complied in good faith with policies designed to ensure the selection and monitoring of its qualified representatives. Similarly, the independent representative must also affirm that it has policies in place to ensure that it meets the requirements highlighted above, as well as a legal obligation to comply with those requirements.

For a counterparty that is an ERISA plan, a Swap Registrant must have a reasonable basis to believe that the counterparty has a "fiduciary" as defined by applicable law. In that situation, a Swap Registrant will satisfy its "reasonable basis" obligation if the ERISA plan provides the name and contact information for the plan's representative and states that the representative qualifies as a fiduciary under ERISA, regardless of the nature of the Special Entity. However, if the transaction is executed on a DCO or SEF and the Swap Registrant does not know the identity of the counterparty before execution, these rules will not apply.

counterparty should enter into any swap. If an employee of the swap dealer expresses an opinion in violation of this declaration, the swap dealer will not be protected by the original disclaimer. CFTC staff noted that it would consider all relevant facts and circumstances surrounding an alleged violation when deciding whether to bring an enforcement action against a swap dealer under this provision.

14 *See* Phyllis C. Borzi, *Final Business Conduct Standards Rules Adopted January 11, 2012*, Department of Labor, 1 (January 17, 2012) (noting further that the Business Conduct Standards do not conflict with current Department of Labor regulations).

15 The CFTC has added a new exclusion from the CTA definition for a swap dealer whose recommendation or advice is solely incidental to its business as a swap dealer.

The final rules include a two-year prohibition on a swap dealer entering into swaps with a governmental Special Entity when such swap dealer makes certain political contributions to officials of such Special Entity.

Proposed "Volcker Rule"

The CFTC released for public comment a rule proposal (the Proposed CFTC Volcker Rule) implementing Section 619 of the Dodd-Frank Act,[16] which outlines certain prohibitions and limitations on the ability of banking entities and nonbank financial companies supervised by the Board of Governors of the Federal Reserve System (Board) to engage in proprietary trading of securities, derivatives, and certain other financial instruments.[17] Whereas banking entities are prohibited from engaging in such activities, nonbank financial companies supervised by the Board would be subject to trading limits and capital charges if they engage in such trading activities. In addition, banking entities and nonbank financial companies supervised by the Board would be limited in their holding of certain interests in, or relationships with, hedge funds and private equity funds[18] (covered funds), subject to several exemptions.

The CFTC has the latitude to exempt additional activities—which it declined to do in the Proposed CFTC Volcker Rule—as well as determine whether funds that do not meet the definition of "hedge fund" or "private equity fund" would nevertheless be considered covered funds. In the Proposed CFTC Volcker Rule, the CFTC expanded the universe of covered funds to include

16 Section 619 of the Dodd-Frank Act created new Section 13 of the Bank Holding Company Act.

17 Certain activities would be exempt from the Joint Volcker Rule (defined below) trading prohibitions, including: trading in certain government obligations; underwriting and market making-related activities; risk-mitigating hedging activities; trading on behalf of customers, investments in Small Business Investment Companies, and public interest investments; trading for the general account of insurance companies; organizing and offering a covered fund (defined below), including limited investments in such funds; foreign trading by non-U.S. banking entities; and foreign covered fund activities by non-U.S. banking entities.

18 "Hedge fund" and "private fund" mean "any issuer that would be an investment company, as defined in the [Investment Company Act, as amended], but for Section 3(c)(1) or 3(c)(7) of that Act." Section 13(h)(2) of the Bank Holding Company Act.

commodity pools and the foreign equivalent of any covered funds.

The Proposed CFTC Volcker Rule is largely identical to the joint rule proposal issued by the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission in October 2011 (Joint Volcker Rule).[19] The CFTC has modified the Joint Volcker Rule primarily to the extent necessary to add CFTC-specific provisions and requests for comment. The CFTC has asked, among other things, whether certain provisions of the Joint Volcker Rule should apply to CFTC-regulated banking entities.

The Joint Volcker Rule and the Proposed CFTC Volcker Rule are anticipated to have significant direct ramifications for the operations of the sell-side of the commodity trading market which is comprised of many banking entities, but less so for the operations of the buy-side that includes asset managers of mutual funds, private funds, and separately managed accounts. However, the Joint Volcker Rule and the Proposed CFTC Volcker Rule are very controversial on both the sell-side and buy-side, and currently do not clarify many activities and restrictions, including the extent to which certain activities will be permitted or prohibited market-making or hedging activities. Restrictions on such activities could limit buy-side accessibility to the derivative markets and liquidity in such markets.

The Proposed CFTC Volcker Rule would establish requirements for banking entities to create internal compliance programs to govern their covered trading and covered fund activities. Such compliance programs would be subject to oversight by the entities' respective regulatory authorities. To the extent that banking entities are not compliant with these requirements, the Proposed CFTC Volcker Rule does not create any enforcement authority for the CFTC. That authority would remain with the bank regulators under the Bank Holding Company Act. The Proposed CFTC Volcker Rule would also not cover all banking activities, but only the activities over which the CFTC is the primary regulator.

The comment period on the Proposed CFTC Volcker Rule is 60 days after the date of publication in the *Federal Register*.

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[19] For a more detailed discussion of the Joint Volcker Rule, *see DechertOnPoint* Volcker Rule Regulations Proposed, *available at* http://www.dechert.com/files/Publication/5da2278f-a70f-48f2-aa40-1128f5a33c75/Presentation/PublicationAttachment/7ebe82c3-9bb9-4c4a-8c4a-06a08262a589/Financial_Institutions_13-10-11-Volcker_Rule_Regulations_Proposed.pdf.

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