[Fordham Journal of Corporate & Financial Law](https://ir.lawnet.fordham.edu/jcfl)

Volume 18 | Issue 2 Article 3

2013

The Impact of Dodd-Frank on Derivatives

M. Holland West

Matthew K. Kerfoot

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Cover Page Footnote

The authors (Partners at Dechert LLP, New York) gratefully acknowledge the contribution and assistance on this paper by their colleague, Frederick Quenzer (Associate).

VOLUME XVIII 2013 NUMBER 2

FORDHAM

JOURNAL OF
CORPORATE & FINANCIAL LAW

SYMPOSIUM

THE REGULATION OF OVER-THE-COUNTER DERIVATIVES

THE IMPACT OF DODD-FRANK ON DERIVATIVES

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I. DODD-FRANK OVERVIEW

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), enacted on July 21, 2010, provides for the first time a comprehensive regulatory framework for the over-the-counter ("OTC") derivatives markets.[1] Fundamentally, Title VII aims to prevent future financial crises by mandating robust market level and transaction level transparency, while reducing structural leverage and systemic risk throughout the derivatives markets.[2]

While significant portions of Title VII remain subject to further rulemaking by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") (jointly, "Commissions"), Title VII codifies the global de-risking process that has been underway since the 2008–09 financial crisis, with a particular focus on:

- Reducing counterparty risk and enhancing transparency and price discovery by requiring clearing and exchange trading of eligible derivatives contracts;
- Deleveraging the OTC derivatives markets by imposing new regulatory capital and margin requirements on OTC swap dealers ("swap dealers") and certain large OTC swap participants ("major swap participants");
- Requiring swap dealers and major swap participants to register with the SEC and/or CFTC and to continuously disclose detailed information regarding their derivatives trading activities; and
- Prohibiting U.S. Federal guarantees and other Federal assistance from being provided to insured depository institutions involved

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S. Code). Pursuant to Section 701 of the Dodd-Frank Act, Title VII may be cited as the "Wall Street Transparency and Accountability Act of 2010."

2. Luis A. Aguilar, Commissioner, Sec. & Exch. Comm'n, Address at SEC Open Meeting: Protecting Our Economy Demands Adequate Capital and Margin Requirements for Security-Based Swaps (Oct. 17, 2012), *available at* http://www.sec.gov/news/speech/2012/spch101712laa.htm.

in the swaps markets, subject to exceptions for certain types of swaps activities and affiliated swap dealers.

A. Jurisdiction

Dodd-Frank allocates jurisdiction over the OTC derivatives markets between the SEC for "security-based swaps" and certain participants in the security-based swaps markets, and the CFTC for all other "swaps" and certain participants in the swaps markets. The SEC, for example, will be the regulatory authority responsible for imposing new capital and margin requirements on security-based swaps, such as equity swaps, forwards, and options, while the CFTC will have analogous authority over all swaps other than security-based swaps, such as commodity swaps, forwards, and options.[3]

B. Effective Date

Significant portions of the Title VII legislation and mandated rule-making were scheduled to take effect on July 16, 2011.[4] The CFTC first granted temporary relief on July 14, 2011 to extend the deadline to December 31, 2011.[5] At its December 19, 2011 meeting, the CFTC further extended the effective date to July 16, 2012.[6]

3. Dodd-Frank Act, Pub. L. No. 111-203, § 716, 124 Stat. 1376, 1648 (2010) (to be codified at 15 U.S.C. § 8305).

4. *See id.* § 754 ("Unless otherwise provided in this title, the provisions of [subtitle A of title VII of the Dodd-Frank Act] shall take effect on the later of 360 days after the date of the enactment of this subtitle or, to the extent a provision of this subtitle requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provision of this subtitle."). The general effective date for provisions of title VII that do not require a rulemaking was July 16, 2011.

5. Effective Date for Swap Regulation, 76 Fed. Reg. 42,508 (July 19, 2011).

6. Amendment to July 14, 2011 Order for Swap Regulation, 76 Fed. Reg. 80,233 (Dec. 23, 2011). Editor's note: Since the date of this article, the CFTC further extended the effective date to December 31, 2012.

II. OTC DERIVATIVES SUBJECT TO DODD-FRANK

A. SWAPS

Dodd-Frank is intended to cover nearly all commonly traded OTC derivatives, including swaps and options on interest rates, currencies, commodities, securities, indices, and other tangible and intangible items and economic variables.

While a "forward" is not expressly included in the definition of a swap, a physically settled forward sale of a non-financial commodity or security is expressly excluded from the definition.[7] This suggests that other forward contracts are intended to be included in the definition of a "swap."

B. SECURITY-BASED SWAPS

A security-based swap is essentially a transaction that would be categorized as a "swap" but which references a narrow-based security index or a single security or loan, or a swap that is based on the occurrence or non-occurrence of an event relating to a single issuer of a security or the issuers of the securities in a narrow-based index.[8]

C. FOREIGN EXCHANGE SWAPS AND FORWARDS

Foreign exchange ("FX") swaps and forwards are considered "swaps" and subject to regulation under Dodd-Frank, unless the Secretary of the Treasury determines that such transactions should not be regulated under Dodd-Frank.[9] On April 29, 2011, the Secretary of the Treasury issued a Notice of Proposed Determination ("April 2011 Notice") providing that central clearing and exchange trading

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7. Dodd-Frank Act § 721(a) ("The term 'swap' does not include . . . any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.").

8. *See* Securities Exchange Act of 1934 § 3(a), 15 U.S.C. 78c(a) (2006).

9. Even though the Secretary of the Treasury exempts foreign exchange forwards and foreign exchange swaps from Dodd-Frank, they would still be subject to swap reporting requirements (to a swap data repository, if available, or to the CFTC otherwise). *See* Silla Brush, *U.S. Treasury Exempts Foreign Exchange Swaps From Dodd-Frank*, BLOOMBERG (Nov. 16, 2012), http://www.bloomberg.com/news/2012-11-16/u-s-treasury-exempts-foreign-exchange-swaps-from-dodd-frank.html.

requirements would not apply to FX swaps and forwards.[10] Pursuant to the April 2011 Notice:

- A "foreign exchange swap" is defined as "a transaction that solely involves—(A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange and (B) a reverse exchange of [those two currencies] at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange."[11]
- A "foreign exchange forward" is defined as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange."[12]

D. CPOs and Commodity-Based Swaps

Dodd-Frank amends the definition of commodity pool operator ("CPO") to expressly include any person that sponsors a commingled investment vehicle (i.e., pool) for the purpose of investing in, among other things, commodity-based swaps.[13]

E. OTC Derivatives Not Covered

The swap definition excludes, among other products, commodity futures and physically-settled forwards of non-financial commodities for deferred shipment.[14] The "swap" definition also excludes any agreement that is based on a security and entered into with an underwriter for the purpose of raising capital, unless the agreement is entered into to manage a risk associated with capital raising.[15]

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10. Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25,774 (proposed May 5, 2011). The Department of Treasury issued a final determination on this issue on November 16, 2012, but it does not yet appear in the Federal Register.
11. *Id.* at 25,776.
12. *Id.*
13. *See* Dodd-Frank Act, Pub. L. No. 111-203, § 721(a), 124 Stat. 1376, 1659 (2010).
14. *Id.* § 721(a), 124 Stat. at 1667.
15. *Id.*

III. SUBSTANTIVE REGULATION OF SWAPS

A. MANDATED CLEARING OF SWAPS

Title VII requires clearing of all swap transactions that are acceptable to a "derivatives clearing organization" ("DCO"), other than, as discussed below, any swap for which one of the counterparties is a commercial end-user.[16] A DCO must submit to the SEC or CFTC for prior approval any group, category, type, or class of swaps the DCO seeks to clear.[17] To avoid delays, the relevant Commission must respond to any such DCO request within ninety days of the submission of the request.[18]

DCOs are required to treat all swaps submitted to the DCO with the same terms and conditions as economically equivalent within the DCO and such swaps may be offset with each other.[19] DCOs are further required to provide for non-discriminatory clearing of a swap executed bilaterally or on or through the rules of an unaffiliated contract market or swap execution facility ("SEF").[20] A SEF is a facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants in the facility or system through any means of interstate commerce.[21]

1. OTC Swaps Grandfathered from Clearing Requirements

Swaps entered into before the date of enactment of Dodd-Frank are exempt from the clearing requirements, provided that these swaps are reported to a swap data repository ("SDR").[22]

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16. *See id.*, § 723(a), 124 Stat. at 1675–76.
17. *Id.* § 723(a), 124 Stat. at 1676.
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*
22. *See id.* § 723(a), 124 Stat. at 1679 ("Swaps entered into before the date of the enactment of this subsection shall be reported to a registered swap data repository or the Commission no later than 180 days after the effective date of this subsection.").

B. MANDATED EXCHANGE-TRADING OF SWAPS

Title VII mandates that a swap that is cleared on a DCO must be traded on a board of trade designated as a "contract market" (i.e., a futures exchange) or SEF.[23] This execution requirement does not apply if the designated contract market ("DCM") or SEF does not make the swap "available to trade."[24] To establish a process through which registered SEFs and DCMs could make a swap available to trade for the purposes of this execution requirement, the CFTC at its December 5, 2011 meeting ("December 2011 Meeting") proposed Rules 37.10 and 38.12.[25]

Under the proposed rules, DCMs or SEFs must consider a series of factors in determining whether a swap is suitable for trading, including:

- Whether there are ready and willing buyers and sellers;
- The frequency or size of transactions on DCMs or SEFs, or of bilateral transactions;
- The trading volume on DCMs or SEFs, or of bilateral transactions;
- The number and type of market participants;
- The bid/ask spread;
- The usual number of resting firm or indicative bids and offers;
- Whether a DCM's trading facility or a SEF's trading system or platform will support trading in the swap; and
- Any other factor that the DCM or SEF may consider relevant.[26]

Once the initial determination is made, the DCM or SEF must then submit the swap to the CFTC for approval or self-certification.[27]

In addition, any other DCM or SEF that lists or offers a swap for trading must make that swap available to trade, including any swaps that are "economically equivalent" to the original swap. Any

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23. *Id.* § 723(a), 124 Stat. at 1681.
24. *Id.*
25. Process for a Designated Contract Market or Swap Execution Facility to Make a Swap Available to Trade, 76 Fed. Reg. 77,728 (proposed Dec. 14, 2011).
26. *Id.* at 77,732.
27. *Id.* at 77,736.

decision to make a swap available by a DCM or SEF must be reviewed on an annual basis to determine if such designation should continue.[28]

C. PROTECTION OF CLEARED SWAP ACCOUNTS AND COLLATERAL

At its January, 11 2012 meeting ("January 2012 Meeting"), the CFTC promulgated final segregation requirements for cleared swaps.[29]

Specifically, the CFTC adopted a new Part 22 of its rules, which implements the "Complete Legal Segregation Model" or "LSOC Model" ("legal segregation with operational commingling"). This model permits collateral for the cleared swaps customers of a futures commission merchant ("FCM") to be placed in one "omnibus" customer account pre-bankruptcy, although it is required to be segregated from the FCM's property.[30]

In the event of an FCM's bankruptcy, if there is a shortfall in the cleared swaps customer account that is attributable to a cleared swaps customer loss that exceeds both its collateral and the FCM's ability to pay, the DCO may only use the collateral that is "attributable to defaulting customers [whose portfolios of positions at the DCO suffered losses] to meet the loss."[31]

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.[32]

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28. *Id.* at 77,732.

29. Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6336 (Feb. 7, 2012).

30. *Id.*

31. *Id.* at 6340.

32. *Id.*

1. Segregation Models[33]

a. LSOC Model

The buy-side market has been extremely interested in the LSOC Model. Although the intention of implementing central clearing of swaps and posting of associated collateral is the reduction of systemic risk, the removal of all risk will not be possible. The LSOC Model includes the following risks:

- Creating a potential single point of failure by using a central clearing organization;
- Posting collateral to a central counterparty makes all parties' collateral potentially available to an FCM and DCO in the case of a single party's default;
- Creating 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; and
- Mutualizing risk to the extent that, if an FCM fails and there is a shortfall in required collateral, all cleared swap customers could face losses on a pro rata basis. In the OTC market, when mutual funds, certain private funds, and other participants post collateral to third-party segregated/custody accounts, the risk of proportionate sharing of loss is mitigated.

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.

b. Physical Segregation Model

The CFTC considered full physical segregation ("Physical Segregation Model") for cleared swaps customer collateral.[34]

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33. For an overview of the different segregation alternatives considered by the CFTC, see id. at 6339–40.

34. *Id.* at 6339.

The Physical Segregation Model differs from the LSOC Model in that each FCM and DCO maintains a separate individual account for each customer for the relevant collateral.[35] As a result, the FCM ensures that the DCO does not use the collateral of one cleared swaps customer to support the obligations of another customer, by ensuring that the DCO does not transfer collateral in the account belonging to one such customer to an account belonging to another.[36] This model was not adopted due to the potential increased costs involved.

c. Commodity Futures and Options Model

The CFTC considered using the segregation requirements currently applicable to the exchange-traded commodity futures and options markets ("Futures Model").[37] This model requires separate accounting for and segregation of associated customer funds and property from the FCM's property. However, operational commingling of funds and property of all customers is still permitted.[38]

Each FCM identifies, on its books and records, the cleared swaps that an FCM intermediates on an "omnibus" basis prior to a double default (i.e., a default of one or more customers and the FCM). Following a double default, the DCO would be permitted to access the collateral of the non-defaulting cleared swaps customers before applying its own capital or the guaranty fund contributions of the non-defaulting FCM members.[39]

2. Investment of Customer Collateral

Cleared swaps customer collateral may only be invested pursuant to CFTC Rule 1.25, which sets forth the limited universe of permitted investments in which an FCM may invest collateral posted against cleared swaps and exchange-traded futures and options. At its December 2011 Meeting, the CFTC amended Rule 1.25 to remove the following investments from the list of permitted investments:[40]

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35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.* at 6340.
40. Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 76 Fed. Reg. 78,776 (Dec. 19, 2011).

- Corporate debt obligations not guaranteed by the United States;
- Foreign sovereign debt; and
- In-house and affiliate transactions.[41]

The CFTC's amendments to Rule 1.25 and related Rule 30.7 are discussed in greater detail below.

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

At its January 2012 Meeting, the CFTC concluded that the 2005 Amendment to Financial and Segregation Interpretation No. 10 on the Treatment of Funds Deposited in Safekeeping Accounts ("Segregation Interpretation 10-1") does not apply to cleared swaps.[42] Instead of posting collateral directly to the FCM, cleared swaps customer collateral may be deposited in a third-party safekeeping account without the FCM violating the new Section 4d(f) of the Commodity Exchange Act ("CEA").[43] Section 4d(f) imposes certain requirements on FCMs and DCOs relating to cleared swaps and associated collateral.[44]

A FCM must comply with all of the conditions set forth in Segregation Interpretation 10-1, as originally issued in 1984, if the FCM allows the use of a third-party account.[45] Although the use of such third-party accounts is not prohibited, such collateral constitutes customer property within the meaning of the Bankruptcy Code ("Bankruptcy Code").[46]

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41. *Id.* at 78,778.

42. Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. at 6343.

43. *Id.*

44. *See* Dodd-Frank Act, Pub. L. No. 111-203, sec. 724, §§ 4d(f), 124 Stat. 1376, 1682–83 (2010) (to be codified at 7 U.S.C. § 6d(f)).

45. Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. at 6343.

46. *Id.*

4. FCM Bankruptcy Rules

At its January 2012 Meeting, the CFTC amended Part 190 of its rules to implement Dodd-Frank's changes to the Bankruptcy Code to, among other things:[47]

- Include swaps cleared with a DCO as customer contracts for commodity brokers;
- Include SEFs as a category of trading venue; and
- Reflect certain swap market practices (e.g., providing for auctions of swap portfolios in the event of an FCM insolvency).

D. REAL-TIME SWAP CLEARING RULES

On March 20, 2012, the CFTC finalized rules that require swap dealers to make near real-time, or "as soon as technologically practicable," decisions whether to clear a swap transaction.[48] The rules provide for new documentation in regards to clearing, time frames for submission and acceptance for clearing, and risk management for clearing members.

1. Clearing Documentation Rules

Because such agreements could unduly influence a customer's choice of counterparties or clearing members, tri-party agreements among customers and swap dealers, major swap participants, FCMs that are clearing members, and DCOs are prohibited.[49] In addition, agreements between a customer and any one FCM, swap dealer, major swap participant, or DCO may not:

- Disclose the identity of a customer's original executing counterparty to an FCM, swap dealer, or major swap participant;
- Limit the number of counterparties with which a customer may enter into a trade;

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47. *See id.* at 6360.

48. Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. 21,277, 21,281 (Apr. 9, 2012).

49. *Id.* at 21,279–80.

- Restrict the size of a customer's position with any individual counterparty, except an overall credit limit for all positions held by the customer at the FCM;
- Reduce the ability of a customer to execute a trade on terms that are reasonably related to the best terms available; or
- Prevent compliance with specified time frames for acceptance of trades into clearing.[50]

2. Time Frames for Submission and Acceptance of Trades

A clearing member, or a DCO acting on its behalf, must accept or reject each trade submitted for clearing as quickly as "would be technologically practicable if fully automated systems were used."[51] Actions must be taken within milliseconds, with a maximum period of time being minutes.[52] These systems do not necessarily have to be automated, as long as a manual system can operate within the same time frame as an automated system.[53]

A swap dealer, major swap participant, FCM, SEF, and DCO must submit cleared swaps as soon as technologically practicable after execution, but no later than close of business on the day of execution.[54] If a swap is not required to be cleared, it must be submitted for clearing to a DCO not later than the next business day after execution of the swap, or the agreement to clear if this is later than execution of the swap.[55]

3. Risk Management Rules for Clearing Members

Swap dealers, major swap participants, and FCMs that are clearing members must:

- Create credit and market risk-based limits based on position size, order size, margin requirements, or similar factors;

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50. *Id.* at 21,279.
51. *Id.* at 21,285.
52. *Id.* ("The Commission recognizes that processing times may vary by product or market").
53. *Id.*
54. *Id.* at 21,281.
55. *Id.*

- Automate the means used to screen orders for compliance with risk-based limits;
- Monitor adherence to risk-based limits intra-day and overnight;
- Conduct stress tests at least once per week of all positions in the proprietary accounts and any customer accounts that may pose a substantive risk to the FCM;
- Evaluate at least once a week the ability of the swap dealer, major swap participant, or FCM to meet initial margin requirements and variation margin requirements in cash, and once a month its ability to liquidate positions it clears in an orderly manner, and estimate the cost of the liquidation; and
- Test at least once per quarter all lines of credit.[56]

E. PROPOSED MARGIN REQUIREMENTS FOR UNCLEARED SWAPS

1. Proposal of Prudential Regulators

On April 12, 2011, the Federal Reserve Board ("Federal Reserve"), the Office of the Comptroller of Currency, the Federal Deposit Insurance Corporation ("FDIC"), the Farm Credit Administration, and the Federal Housing Finance Authority (collectively "Prudential Regulators") proposed rules that would establish minimum initial and variation margin requirements for uncleared swaps entered into by certain swap dealers and major swap participants ("Prudential Regulators' Margin Proposal").[57]

Dodd-Frank requires a swap dealer or major swap participant that, in lieu of being regulated by the CFTC and/or SEC, is regulated by a Prudential Regulator to meet the requirements set by such Prudential Regulator. The Prudential Regulators are tasked with creating margin requirements for U.S. federally-insured deposit institutions, farm credit banks, Federal home loan banks, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association.[58]

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56. *Id.* at 21,287.

57. *See* Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,563 (May 11, 2011).

58. *See* Dodd-Frank Act, Pub. L. No. 111–203, sec. 731, § 4s(e), 124 Stat. 1376, 1704–05 (2010); *id.* sec. 764(a), § 15F(e), 124 Stat. at 1786–88.

If there is no Prudential Regulator, Dodd-Frank requires the swap dealer or major swap participant to meet the requirements imposed by the CFTC and SEC regarding margin and capital.[59]

a. Counterparties

Margin requirements under the Prudential Regulators' Margin Proposal are based on the type of counterparty. Four types of derivative counterparties are identified in the proposal: (1) swap dealers or major swap participants; (2) high-risk financial end-users; (3) low-risk financial end-users; and (4) non-financial end-users.[60]

Definitions:

- A "financial end-user" is any counterparty, which is not a swap dealer or major swap participant, that meets the following requirements:
  - Commodity pool;[61]
  - Private fund;[62]
  - Employee benefit plan;[63]
  - Primarily engaged in activities that are the business of banking or "financial" in nature;
  - Would qualify as a commodity pool or private fund, if the entity were organized under the laws of the United States; and
  - Entity that is designated by the Prudential Regulators as a "financial end-user."[64]

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59. *See id.*, sec. 731, § 4s(e), 124 Stat. at 1704–05; *id.* sec. 764(a), § 15F(e), 124 Stat. at 1786–88.
60. *See* Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. at 27,570.
61. As defined in the Commodity Exchange Act § 1a(5), 7 U.S.C. § 5 (2006)
62. As defined in the Investment Advisors Act of 1940 § 202(a), 15 U.S.C. 80b-2(a) (2006).
63. As defined in the Employee Retirement Income and Security Act of 1974 § 3(3), 29 U.S.C. 1002 (2006).
64. As defined in the Bank Holding Company of 1956 § 4(k), 12 U.S.C. § 1843(k) (2006).

Foreign Covered Swap Entities:

The Prudential Regulators' Margin Proposal does not require a "foreign non-cleared swap or foreign non-cleared security-based swap" of a "foreign covered swap entity" to utilize the same margin requirements as other entities.[65] "Foreign non-cleared swap or foreign non-cleared security-based swap" is defined as a swap in which the counterparty is not organized under U.S. law, not located in the United States, and there has been no guarantee of the counterparty's obligations in the transaction by a U.S. affiliate of the counterparty.[66] A "foreign covered swap entity" is a swap dealer or major swap participant not organized under U.S. law, not controlled by another company organized under U.S. law, and is not a U.S. branch, agency, or subsidiary of a foreign bank.[67]

b. Initial Margin Requirements

A swap dealer or major swap participant may utilize either of the two proposed methods of calculating its initial margin requirements under the Prudential Regulators' Margin Proposal.[68]

- "Look-Up" table: initial margin requirements may be calculated using a standard "look-up" table that specifies the minimum initial margin that must be collected, expressed as a percentage of the notional amount of the swap. The minimum initial margin varies depending on the broad asset class of the swap.[69]
- Internal Margin Model: the minimum initial margin requirement may be calculated using an internal margin model that meets specified criteria approved by the relevant Prudential Regulator. At least the amount of initial margin

65. *See* Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. at 27,581.
66. *Id.*
67. *Id.*
68. Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. at 27,567–68.
69. *Id.*

that is required under its internal model calculations must be collected by the swap dealer or major swap participant.[70]

2. Eligible Collateral

The Prudential Regulators' Margin Proposal provides requirements for what can be used as eligible collateral.[71]

Eligible collateral for all purposes includes:

- Cash funds that are immediately available; and
- Direct obligations of the United States, or that are fully guaranteed as to principal and interest by the United States.

Eligible collateral for initial margin purposes only:

- Senior debt obligations of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks, and the Federal Agricultural Mortgage Corporation; and
- Obligations that are "insured obligations" of the Farm Credit Systems banks.[72]

3. Segregation Requirements

An independent, third-party custodian must segregate the initial margin and must be prohibited by contract from (a) rehypothecating or otherwise transferring any initial margin it holds, and (b) reinvesting any initial margin held by the custodian in any asset that would not qualify as eligible collateral for initial margin.[73] The insolvency regime that would be applicable to the custodian must also apply to the swap dealer

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70. Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. at 27,568.
71. *Id.*
72. *Id.*
73. Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. at 27,578.

or major swap participant.[74] A counterparty that is an end-user of any type need not meet the segregation requirement.[75]

4. Variation Margin Requirements

The formula for the amount of variation margin is set by the Prudential Regulators' Margin Proposal as equal to or greater than the cumulative mark-to-market change in value to the swap dealer or major swap participant of a swap minus the value of all variation margin previously collected by the swap dealer or major swap participant with respect to the swap and not returned.[76] At least once per business day for financial end-users or counterparties that are swap entities, variation margin must be collected. Variation margin may be collected at least once per week for non-financial end-users.[77]

A swap dealer or major swap participant is permitted to assess variation margin on an aggregate basis across all swaps with a counterparty if a master netting agreement is in place with that counterparty.[78]

To qualify as a master netting agreement for this purpose, it must be a legally enforceable agreement that offsets positive and negative mark-to-market values of one or more swaps that adhere to specific criteria, which ensures the offset rights are fully enforceable, documented, and monitored by the swap dealer or major swap participant.[79]

5. CFTC's Proposed Margin Requirements for Uncleared Swaps

On April 12, 2011, the CFTC issued a proposal ("CFTC's Margin Proposal") substantially similar to the Prudential Regulators' Margin Proposal that would establish margin requirements for uncleared swaps

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74. *Id.*
75. *Id.* ("This segregation requirement applies only to initial margin, not variation margin, and does not apply to transactions with a counterparty that is an end user of any type.").
76. Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. at 27,588.
77. Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. at 27,589.
78. *Id.*
79. *Id.*

entered into by swap dealers and major swap participants subject to CFTC jurisdiction.[80]

As with the Prudential Regulators' Margin Proposal, the CFTC's Margin Proposal contemplates different requirements depending on the category of the counterparty, using substantively the same categories as the Prudential Regulators.[81] In contrast to the Prudential Regulators' Margin Proposal, the CFTC Margin Proposal would not impose any margin requirements on non-financial end-users and instead requires that a swap dealer or major swap participant have credit support arrangements in place, but does not set forth any initial or variation margin requirements for non-financial end-users.[82]

The CFTC's Margin Proposal requires that a swap dealer or major swap participant calculate hypothetical initial and variation margin amounts for positions held by non-financial end-users, which calculations are only to serve as risk management tools to measure exposure, not to set requirements.[83]

Another important difference between the Prudential Regulators' Margin Proposal and the CFTC Margin Proposal is that the CFTC only requires initial margin to be held at a custodian only if the counterparty is another swap dealer or major swap participant.[84]

The CFTC's Margin Proposal and the Prudential Regulators' Margin Proposal would not apply to swaps entered into before the effective date.

F. REPORTING AND RECORDKEEPING FOR SWAPS

On December 20, 2011, the CFTC adopted final rules requiring real-time public reporting for swap transaction and pricing data ("Public Reporting Rules"). Under these rules, transaction and pricing data must be reported to the appropriate SDR, when registered and operational, for:

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80. Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (proposed Apr. 28, 2011).

81. *Id.* at 23,734.

82. *Id.* at 23,736.

83. *Id.* at 23,736–37.

84. *Id.* at 23,744.

- Any executed swap that is an arm's-length transaction between two parties that results in a corresponding change in the market risk position between such parties;[85] and
- Any termination, assignment, novation, exchange, transfer, amendment, conveyance, or extinguishing of rights or obligations of a swap that change the pricing of such swap.[86]

On February 23, 2012, the CFTC adopted final rules specifying the requirements that swap dealers and major swap participants must comply with in their reporting, recordkeeping, and retention of daily trading records.[87]

1. Reporting Responsibilities

Reports are required regardless of whether the swaps are executed on a regulated trading platform (such as a SEF or DCM) or off-facility (i.e., bilaterally).[88] The responsibility for reporting an off-facility swap transaction resides with the "reporting party":[89]

- If only one party is a swap dealer or major swap participant, then that party is the reporting party;
- If one party is a swap dealer and the other is a major swap participant, then the swap dealer is the reporting party;
- If both parties are either swap dealers or major swap participants, then the parties must agree which one will be the reporting party; and
- If neither party is a swap dealer or major swap participant, then the parties must agree which party will be the reporting party.

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85. Real-Time Public Reporting of Swap Transaction Data, 77 Fed. Reg. 1182, 1244 (Jan. 9, 2012).

86. *Id.*

87. *See* Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules, 77 Fed. Reg. 20,128 (Apr. 3, 2012).

88. *See* Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2135, 2142–43 (Jan. 13, 2012).

89. *Id.* at 2143–44.

The SDR is responsible for disseminating the swap transaction and pricing data it receives as soon as technologically practicable.[90] Such dissemination is subject to certain provisions and time delays that are designed to protect market participants' anonymity and transaction liquidity. Data that identifies or facilitates the identification of a party to a swap will not be publicly available. However, a party reporting swap data to an SDR must include an actual description of the underlying assets, and such information will be publicly available for those swap transactions in the interest rate, credit default, equity, and FX asset classes. Swaps with other underlying commodity assets will be publicly available for swap transactions involving any of the 28 "enumerated physical commodity contracts" identified in the CFTC's finalized position limits rules (discussed below) plus Brent Crude Oil, and any publicly reportable swap transactions economically related to one of those physical commodity contracts.

a. Caps on Reporting Amounts

The Public Reporting Rules place caps, under certain circumstances, on the notional or principal amount of a swap transaction that will be made publicly available.

- For interest rate swaps, the amount publicly disseminated for swaps with a term:
    - From zero to two years, the cap is set at $250 million;
    - Greater than two years but less than or equal to ten years, the cap is set at $100 million; and
    - Greater than ten years, the cap is set at $75 million.
- For credit default swaps, the cap is set at $100 million.
- For equity swaps, the cap is set at $250 million.
- For FX swaps, the cap is set at $250 million.
- For other commodity swaps, the cap is set at $25 million.

90. *Id.*

2. Time Frame for Implementation

Compliance dates for the Public Reporting Rules will be phased in according to the type of market participant and underlying asset.[91]

- July 16, 2012: all SEFs, DCMs, swap dealers, and major swap participants will be required to report interest rate and credit default swap transaction data.
- October 14, 2012: all SEFs, DCMs, swap dealers, and major swap participants will be required to report swaps on the remaining types of underlying assets.
- January 12, 2013: remaining market participants will be required to report their swaps.

3. Ramification of Reporting Rules

The Public Reporting Rules will have two consequences for asset managers:

- Swap position data for all market participants will be available on an anonymous basis to the public; and
- Regulators, such as the CFTC, will have access to data for all market participants on a named basis, allowing the CFTC to aggregate swap positions and ensure compliance with regulations.

In addition, an asset manager may, in certain circumstances, be required to report necessary swap data to an SDR, or agree with its swap counterparty as to which party will provide such reporting, when managing a fund or account engaged in off-facility swaps.

4. Content Rules

The CFTC finalized rules regarding the content of swap reporting and recordkeeping. Specifically the new rules require:

Swap creation data, which is data that encompasses the primary economic terms ("PET")[92] and confirmation data for each swap, must be reported if:

91. *Id.* at 2195–96.
92. *Id.* at 2147.

- The SEF or DCM executed the swaps; and
- An off-facility swap is accepted by a DCO for clearing within the PET data deadline.[93]

For off-facility swaps that are subject to the mandatory reporting requirement but not accepted for clearing by a DCO, one of the counterparties must act as the reporting counterparty, based on the same procedure as determining the reporting party.

Smaller swap participants and non-swap dealer/major swap participant counterparties (e.g., many mutual funds, private funds, and separately managed accounts) are only required to report data to SDRs in limited circumstances.

- If the swap is executed off-facility but accepted for clearance by a DCO within the deadline for the non-swap dealer/major swap participant reporting counterparty to submit PET data to an SDR, the DCO will assume the reporting obligations of the non-swap dealer/major swap participant reporting counterparty.
- When a DCO accepts an off-facility swap for clearing after the PET deadline, the DCO will be required to provide the confirmation data to an SDR.
- When the swap is executed on a SEF or DCM but is not cleared by a DCO, the non-swap dealer/major swap participant reporting counterparty will be required to provide data on the swap to an SDR for the life of the swap.

5. Maintenance of Records

Each SEF, DCM, DCO, swap dealer, and major swap participant must maintain "full, complete, and systematic" records of its respective activities related to swap transactions.[94] Non-swap dealer/major swap participant counterparties must maintain similar records for any swaps to which they are a counterparty.[95]

93. *Id.* at 2138.
94. *Id.* at 2198.
95. *Id.*

Parties must retain these records for the duration of the swap and for a period of five years following its termination.[96] SEFs, DCMs, DCOs, swap dealers, and major swap participants must maintain these records in a format prescribed by the CFTC, and be capable of retrieving such records within three business days during the duration of the swap and for two years following its expiration. Non-swap dealer/major swap participant counterparties must be able to retrieve their records within five business days for the entire retention period.

The CFTC will have real-time access to the records in an electronic format during the life of a swap and for five years after its termination.

6. Final Reporting Requirements

a. Recordkeeping[97]

Swap dealers and major swap participants are required to:

- Maintain full and complete transaction and position information for all swap activities, and such information must include all documents on which the trade information was originally recorded;
- Provide all transaction records in a system that is identifiable and searchable by transaction and by counterparty;
- Keep business records, including but not limited to minutes from meetings of the swap dealer's or major swap participant's governing body, organization charts, audit documentation, certain financial records, complaints against personnel, and marketing materials; and
- Keep records of any information required to be submitted to a SDR and reported on a real-time public basis.

b. Daily Trading Records

The CFTC has issued rules that mandate daily trading record requirements, including:

96. *Id.*
97. *Id.* at 2198–99.

- Records of trade information related to pre-execution, including records of all oral and written communications that lead to the execution of a swap;
- Execution data, including terms of executed swaps, and date and time that each swap was executed (to the nearest minute); and
- Post-execution data, including records of all confirmations, reconciliations, and margining of swaps.

Swap dealers and major swap participants are required to preserve all information necessary to conduct a comprehensive and accurate trade reconstruction for each swap. In addition, swap dealers and major swap participants must maintain trade records in a form "identifiable and searchable" both by transaction and counterparty. All information must be retained regarding cash or forward transactions used to hedge, offset any swap held by the swap dealer or major swap participant, or mitigate risk.

G. LARGE TRADER REPORTING FOR PHYSICAL COMMODITY SWAPS

On July 22, 2011, the CFTC finalized a rule that requires traders to report their holdings of large physical commodity swap and swaption positions ("Large Trader Reporting Rule").[98] All swaps and swaptions linked to, or priced at a differential to, either the price of any of the forty six physical commodity futures contracts listed below ("Covered Futures Contracts") or the price of the physical commodity at the delivery location of any of the Covered Futures Contracts must be reported.

- Chicago Board of Trade ("CBOT") Corn; CBOT Ethanol; CBOT Oats; CBOT Rough Rice; CBOT Soybean Meal; CBOT Soybean Oil; CBOT Soybeans; CBOT Wheat; Chicago Mercantile Exchange ("CME") Butter; CME Cheese; CME Dry Whey; CME Feeder Cattle; CME Hardwood Pulp; CME Lean Hogs; CME Live Cattle; CME Milk Class III; CME Non Fat Dry Milk; CME Random

98. Large Trader Reporting for Physical Commodity Swaps, 76 Fed. Reg. 43,851 (July 22, 2011).

Length Lumber; CME Softwood Pulp; COMEX ("CMX") Copper Grade #1; CMX Gold; CMX Silver; ICE Futures U.S. ("ICE") Cocoa; ICE Coffee C; ICE Cotton No. 2; ICE Frozen Concentrated Orange Juice; ICE Sugar No. 11; ICE Sugar No. 16; Kansas City Board of Trade Wheat; Minneapolis Grain Exchange Wheat; NYSELiffe ("NYL"), Gold, 100 Troy Oz; NYL Silver, 5000 Troy Oz; New York Mercantile Exchange ("NYMEX") Cocoa; NYMEX Brent Financial; NYMEX Central Appalachian Coal; NYMEX Coffee; NYMEX Cotton; NYMEX Crude Oil, Light Sweet; NYMEX Gasoline Blendstock (RBOB); NYMEX Hot Rolled Coil Steel; NYMEX Natural Gas; NYMEX No. 2 Heating Oil, New York Harbor; NYMEX Palladium; NYMEX Platinum; NYMEX Sugar No. 11; NYMEX Uranium; and Diversified Commodity Index.

1. Definition of Swaps under Large Trader Reporting Rule

Until a final rule defining swap is adopted, a portion of the definition under CFTC Rule 35.1(b)(1) will be used for the purposes of the Large Trader Reporting Rule. For these purposes, a swap is defined as "an agreement (including terms and conditions incorporated by reference therein) which is a commodity swap (including any option to enter into such swap) within the meaning of 'swap agreement' under Rule 35.1(b) (1) . . . , or a master agreement for a commodity swap together with all supplements thereto."[99]

a. Reportable Positions

The Large Trader Reporting Rule requires clearing organizations, clearing members, and swap dealers to report data to the CFTC on "reportable positions" in physical commodity swaps and swaptions. The following process is used to determine what constitutes "reportable positions":

- Identifying the open swaps and swaptions in a principal or a counterparty account that are linked to the price of either a Covered Futures Contract or the same commodity for delivery at the same location or locations as that of a

99. *Id.* at 43,863.

Covered Futures Contract (each a "paired swap" or a "paired swaption"). The following swaps and swaptions are included:

- Those settled by direct or indirect reference, including partial reference, to the price of either a Covered Futures Contract or the same commodity for delivery at the same location or locations as an underlying commodity in a Covered Futures Contract;[100] and
- Those priced at a differential to a Covered Futures Contract or the underlying commodity of a Covered Futures Contract.[101]

- Calculating for each month the number of economically equivalent futures contracts of all paired swaps and swaptions ("futures equivalent"). To calculate this number, the total notional quantity of the swap is multiplied by its remaining duration and then divided by the number of units that make up one futures contract. This number is then allocated pro rata to each month or fraction of a month (based upon the number of days remaining in each month) remaining on the swap. To calculate the futures equivalent for a swaption, the same calculation is performed, but the option delta is used to adjust the calculation.[102]
- If the futures equivalent amount of any paired swaps or paired swaptions in any one month is equal to fifty or more futures equivalent contracts, such paired swaps or swaptions are "reportable positions."[103]

All positions in a clearing member or swap dealer's consolidated account will become part of a relevant reportable position, once an included paired swap or swaption meets or exceeds the fifty contract threshold.[104] Such reportable positions will remain so until the first reporting day after which the account no longer includes a reportable position. Because the CFTC acknowledges that the threshold could be

100. *Id.* at 43,854–55.
101. *Id.* at 43,855.
102. *Id.* at 43,865.
103. *Id.* at 43,856.
104. *Id.*

costly or complex, it provides an alternative method that bypasses the calculation. If the reporting entity is consistent in its approach to all consolidated accounts, it may identify a reportable position as all positions on a gross basis in a consolidated account that are based on the same commodity.[105]

b. Required Reporting

Daily reporting of a reporting entity's principal reportable positions in one or more consolidated accounts is required. Each reporting entity must also report daily data on reportable positions in each counterparty's consolidated account.[106]

c. Recordkeeping Requirements

Each clearing organization, clearing member, and swap dealer will be required to keep all records of transactions in paired swaps or swaptions. CFTC Rule 1.31 provides the specifications required by all records to record the methods used to convert paired swaps or swaptions into futures equivalents.[107] Any person with more than fifty gross all-months-combined futures equivalent positions in paired swaps or swaptions on a particular commodity must keep books and records that record:

- Transactions resulting in such positions;[108]
- Transactions in the cash commodity underlying such positions or its products and byproducts;[109] and
- All commercial activities that are hedged or with risks that are mitigated by such position.[110]

The CFTC may request the books and records and any relevant data concerning the positions, transactions, or activities.[111]

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105. *Id.*
106. *Id.*
107. *Id.* at 43,864.
108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.*

d. Confidentiality of Data

The CFTC is prohibited by the CEA from making public "data and information that would separately disclose the business transactions or market positions of any person or any trade secrets or names of customers" unless disclosing such information was specifically authorized under the CEA.[112] Additional protection is available from the Privacy Act of 1974, which requires the CFTC to ensure that information contained in its record systems is protected.[113]

e. Implementation

The requirements for reports from a swap dealer that is not registered as either an FCM or broker-dealer, not supervised by a Prudential Regulator, and not affiliated with a bank holding company may be modified by the CFTC.[114] The CFTC may make a portion of the Large Trader Reporting Rule ineffective and unenforceable if it determines that SDRs process swap positional data in a manner that the CFTC regards as effective for analyzing trading data.[115]

On November 18, 2011, the CFTC's Division of Market Oversight issued its determination to temporarily accept reports that do not fully comply with the data field requirements of the Large Trader Reporting Rule. This temporary relief expires on March 20, 2012.[116] The CFTC intended that such relief provide additional time to reporting parties to implement compliant reporting systems. However, to rely on this relief, market participants must attempt to comply with the new rules in good faith.

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112. *Id.* at 43,854 (quoting Commodity Exchange Act § 8(a)(1), 7 U.S.C. § 12 (2006)).

113. *See id.*

114. *Id.* at 43,865.

115. *Id.* at 43,857.

116. Editorial note: On May 23, 2012, this no-action relief was extended to July 2, 2012.

IV. REGULATION OF MARKET PARTICIPANTS

A. MAJOR SWAP PARTICIPANT

Title VII classifies a market participant as a major swap participant if it meets any one of the following three tests:

- It is an entity that maintains a "substantial position" in any of the major swap categories (e.g., equities, fixed income, FX), excluding positions held for hedging or mitigating commercial risk and excluding positions maintained by employee benefit plans for hedging or mitigating risks in the operation of the plan;[117]
- It is an entity whose outstanding swaps create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets;"[118] or
- It is a "financial entity" that is "highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency" and that maintains a "substantial position" in any of the major swap categories.[119]

1. Major Swap Participant Tests

At meetings in December 2010 ("December 2010 Meetings"), the CFTC and SEC provided further definitions for major swap participants and swap dealers. The Commissions first proposed two versions of the "substantial position" test.[120]

117. Dodd-Frank Act, Pub. L. No. 111-203, § 721, 124 Stat. 1376, 1663 (2010).
118. *Id.*
119. *Id.*
120. Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80,174 (proposed Dec. 21, 2010).

a. Substantial Position Tests

First Test:

- For a major swap participant, the threshold for the first test for a "substantial position" would be a daily average exposure of $1 billion for each of three of the four major swap categories (equity swaps, commodity swaps, and credit swaps), but $3 billion for the fourth major swap category (interest rate and FX swaps).[121]
- For a major security-based swap participant, the two major swap categories would be security-based credit derivatives and other security-based swaps. The threshold for both categories would be a daily average exposure of $1 billion.[122]
    - Under this first test, swap exposure is netted against collateral posted to secure the swap and the position is calculated on a net basis, taking into account any master netting agreements between the entity and a single counterparty.
- Hedging or mitigating commercial risk means swap activity that is undertaken for broader reasons than what is considered *bona fide* hedging under applicable CFTC rules.[123]
- Hedging or mitigating commercial risk would include swap activity that is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risk results from a fluctuation in interest, currency, or FX rate exposure arising from a person's assets or liabilities, or the potential change in:
    - Value of assets that a person owns, produces, manufactures, processes, or merchandises in the ordinary course of business;
    - Liabilities that a person incurs;
    - Services that a person provides or purchases; or

121. *Id.*
122. *Id.*
123. *Id.*

    - Value related to the previous three categories, arising from FX rate movements.
- A market participant may take advantage of the carve-out for hedging or mitigating risk so long as the underlying activity is "commercial in nature" for purposes of the major swap participant definition. For purposes of the major security-based swap participant definition, a market participant may rely on the carve-out if a swap position is an "economic hedge."[124]

Second Test:

- For swaps in the equity, commodity, or credit categories as well as security-based swaps on instruments of indebtedness and other security-based swaps, the threshold would be a daily average exposure of $2 billion, plus "potential future exposure." For rate swaps, the threshold would be $6 billion, plus such potential future exposure.[125]
    - The Commissions have proposed a complex test based on existing bank capital standards for determining "potential future exposure." This test applies a risk factor to the notional amount of the swap and considers the direction of the swap, as well as accounts for the operation of master netting agreements. The test also significantly discounts the size of the position if it is cleared or subject to daily mark-to-market margining.

b. Substantial Counterparty Exposure Test

At their December 2010 Meetings, the Commissions further defined the substantial counterparty exposure text. Under the proposal, the test aggregates all of an entity's positions regardless of major swap category or whether the positions are held for hedging or in employee benefit plans. If an entity, in the aggregate, maintains uncollateralized swap exposure of a daily average of $5 billion or uncollateralized swap exposure plus potential future exposure (as measured under the second

124. *Id.*
125. *Id.*

substantial position test) of $8 billion, that entity will qualify as a major swap participant.[126]

c. Highly Leveraged Financial Entity Test

At their December 2010 Meetings, the Commissions proposed two different ratios of total liabilities to equity for determining whether a financial entity is highly leveraged: leverage in excess of 8 to 1 or 15 to 1, measured on the last day of the applicable fiscal quarter.[127]

B. SWAP DEALER

1. Definition

Under Title VII, a bank, dealer, and other financial institution active in derivatives markets may be considered to be a swap dealer and subject to similar capital, margin, reporting, and record keeping requirements as a major swap participant if it is a person who:

- Holds itself out as a dealer in swaps;
- Makes a market in swaps;
- Regularly enters into swaps with counterparties in the ordinary course of business for its own account; or
- Engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.[128]

2. Exemptions from Swap Dealer Definition

The following entities are expressly exempt from the swap dealer definition:

- An insured depository institution to the extent it offers to enter into a swap with a customer in connection with originating a loan to that customer;
- An entity that buys or sells swaps for such person's own account, either individually or in a fiduciary capacity, and not as "part of a regular business;" or

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126. *Id.*
127. *Id.*
128. Dodd-Frank Act, Pub. L. No. 111–203, § 721, 124 Stat. 1376, 1670 (2010).

- An entity that engages in a "*de minimis* quantity" of swap dealing in connection with transactions with, or on behalf, of its customers.[129] The Commissions are charged with promulgating regulations to establish factors in making the determination of a *de minimis* quantity. At their December 2010 Meetings, the Commissions proposed the following factors:
    - Maximum of $100 million in aggregate effective notional amount;
    - Maximum of $25 million in aggregate effective notional amount of swaps with "Special Entities" – government plans, employee benefit plans subject to Title I of the Employee Retirement Income Security Act ("ERISA"), and similar counterparties;
    - Maximum of 15 counterparties (other than as a swap dealer) over the past 12 months; and
    - Maximum of 20 swaps as a swap dealer over the past 12 months.[130]

C. CONSEQUENCES OF BEING SWAP DEALER OR MAJOR SWAP PARTICIPANT

1. Registration

At its January 2012 Meeting, the CFTC adopted the following final rules in regards to registration of swap dealers and major swap participants.[131]

- The CFTC will establish a process for the registration of swap dealers and major swap participants, pending the final definitional and compliance rules.[132]
- Swap dealers and major swap participants are required to become and remain members of the National Futures

129. *Id.*
130. Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80,174, 80,180 (proposed Dec. 21, 2010).
131. Registration of Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2613 (Jan. 19, 2012).
132. *Id.* at 2613.

Association ("NFA"), 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.[133]

- To apply for registration as a swap dealer or major swap participant, a person or entity must:
    - File electronically with the NFA a Form 7-R and, for each of its principals, a Form 8-R and a fingerprint card; and
    - Demonstrate compliance with each regulation implemented under new CEA Section 4s(h) then applicable to it, and demonstrate compliance with any other Section 4s regulations implemented by the CFTC, if and as they become applicable.[134]
- The CFTC is delegating authority to the NFA to perform the full range of registration functions for swap dealers and major swap participants, including the processing of applications for registration and confirmation of initial compliance with applicable regulations implementing Section 4s.[135]
- Non-insured depository institution affiliates are subject to the above requirements, although not subject to specific regulations with respect to their activities.[136]
- A person associated with the swap dealer or major swap participant who is subject to a "statutory disqualification" is prohibited from being involved in or effecting swaps if the swap dealer or major swap participant knows, or has reason to know, of the statutory disqualification.[137]

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133. *Id.* at 2626.
134. *Id.*
135. *Id.*
136. *Id.*
137. *Id.*

2. Regulatory Capital and Margin Requirements

As discussed above, each registered swap dealer and major swap participant, and any swap dealer or major swap participant for which there is a Prudential Regulator, must meet new minimum capital standards and initial and variation margin requirements for non-cleared swaps (cleared swaps will be subject to existing margin requirements mandated by the relevant clearing houses).

D. BUSINESS CONDUCT STANDARDS FOR SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

1. Business Conduct Standards

At its January 2012 Meeting, the CFTC adopted business conduct rules ("Business Conduct Rules") that impose due diligence and disclosure requirements on swap dealers and major swap participants.[138] At its February 23, 2012 Meeting, the CFTC added additional requirements concerning monitoring of trades, providing research and disclosure of conflicts of interest, supervision, disaster recovery, and implementing risk management procedures. In addition, the CFTC finalized rules regarding qualifications and responsibilities of executive officers of FCMs.[139]

2. Duties to Counterparties

Swap dealers and major swap participants are required to implement policies and procedures to ensure that they are compliant with the final rules and do not evade the CEA.

a. Information Disclosure

Swap dealers and major swap participants must disclose enough material information about a swap to allow the counterparty to assess (i)

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138. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734 (Feb. 17, 2012).

139. Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 Fed. Reg. 20,128 (Apr. 3, 2012).

the material risks of the swap; (ii) the material characteristics of the swap; (iii) the material incentives for the swap dealer or major swap participant to enter into the swap; and (iv) any conflicts of interest the swap may create.[140]

b. Verification of Status (Eligible Contract Participants and Special Entities)

The Business Conduct Rules require swap dealers and major swap participants to verify that their counterparties are "eligible contract participants" before offering or entering into a swap transaction with those counterparties.[141]

Swap dealers and major swap participants must verify whether a counterparty is, or may choose to be, a Special Entity, defined as:

- A U.S. Federal agency;
- A state, state agency, city, county, municipality, or other political subdivision of a state;
- An ERISA plan;
- A governmental plan, as defined in Section 3 of ERISA;
- An endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code; or
- An employee benefit plan defined in Section 3 of ERISA, not otherwise defined as a Special Entity, that elects to be a Special Entity by notifying the swap dealer or major swap participant of its election prior to entering into a swap with that swap dealer or major swap participant.[142]

In meeting these requirements, a swap dealer or major swap participant may rely on the written representations of its counterparty. Swap dealers and major swap participants will have a reasonable basis to 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.[143]

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140. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9757.

141. *Id.* at 9824.

142. *Id.* at 9822–23.

143. *Id.* at 9826.

Swap dealers and major swap participants are under no obligation to verify a counterparty's status when a transaction is initiated on a DCM or SEF and the swap dealer or major swap participant does not know the identity of the counterparty prior to the transaction.[144]

c. Suitability for Recommended Swaps

Swap dealers must obtain enough information about their counterparties to form a "reasonable basis to believe" that any swap recommended by the swap dealer is suitable for the counterparty.[145] 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.[146] However, a swap dealer is under no obligation to verify a counterparty's status when a transaction is initiated on a DCM or SEF and the swap dealer does not know the identity of the counterparty prior to the transaction.[147]

d. Additional Requirements

Swap dealers and major swap participants must:

- Provide counterparties with a "daily mark that is the mid-market mark of the swap" for any uncleared swaps.[148]
- Communicate with their counterparties in a "fair and balanced manner based on principles of fair dealing and good faith."[149]

When entering into swaps that have not been made available to trade by a DCM or SEF, a swap dealer, but not a major swap participant, must notify a counterparty of its right to request a scenario analysis performed by the swap dealer. This analysis must provide the counterparty with the ability to assess its potential loss under the swap. This rule does not apply to a transaction initiated on a DCM or SEF

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144. *Id.* at 9756.
145. *Id.* at 9770.
146. *Id*.
147. *Id.* at 9756.
148. *Id.* at 9824.
149. *Id.* at 9760.

where the swap dealer does not know the identity of its counterparty before executing the transaction.[150]

3. Disclosures

Swap dealers and major swap participants are required to provide certain clearing disclosures to their counterparties. For cleared swaps, these disclosures include notifying the counterparty of its right to select the DCO for clearing.[151] The Business Conduct Rules provide that these disclosures, and any other communications made to a counterparty, must be made in a fair and balanced manner in accordance with the principles of good faith and fair dealing.[152]

4. Special Duties to Special Entities

The Business Conduct Rules provide additional duties and requirements for swap dealers and major swap participants that enter into swaps with Special Entities. 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.[153] Compliance with these obligations does not subject a swap dealer or major swap participant to the ERISA fiduciary requirements.

a. Non-ERISA Special Entities

A swap dealer or major swap participant entering into a swap transaction with a non-ERISA Special Entity must:

- Have a reasonable basis to believe that the Special Entity has an independent representative that operates in its best interests;
- Not be disqualified from registration under the CEA; and
- Ensure that the Special Entity has sufficient capacity to understand the risks of the transaction.

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150. *Id.* at 9824.
151. *Id.* at 9760–61.
152. *Id.*
153. *Id.* at 9777.

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, it has provided a reasonable basis. The independent representative has, in addition to a legal obligation to comply with the requirements, the obligation to affirm that it has policies in place to ensure that it meets the requirements.

b. ERISA Special Entities

A swap dealer or major swap participant must have a reasonable basis to believe that any ERISA plan counterparty is a "fiduciary" as defined by applicable law.[154] It may satisfy its "reasonable basis" obligation if an 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.[155] These rules do not apply if the transaction is executed on a DCO or SEF and the swap dealer or major swap participant does not know the identity of the counterparty before execution.[156]

The Business Conduct 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.[157]

5. Prohibitions

- Swap dealers and major swap participants are prohibited from engaging in "fraudulent, deceptive, and manipulative practices."[158]
- Swap dealers and major swap participants are prohibited from disclosing or misusing a counterparty's material confidential information.[159]

154. *Id.* at 9794.
155. 17 C.F.R. § 23.450(d)(2) (2012).
156. 17 C.F.R. § 23.450(h) (2012).
157. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9799.
158. *Id.* at 9814.
159. *Id.*

- Confidential information may not be appropriated if doing so would have a material adverse impact on the counterparty.[160]

An affirmative defense exists for alleged violations if the swap dealer or major swap participant can establish that it complied in good faith with relevant policies and procedures and did not act intentionally or recklessly with respect to the alleged fraud or deceit.[161]

6. Risk Management Procedures

Swap dealers and major swap participants must establish adequate risk management procedures. These risk management procedures must contain written policies and procedures that allow for the monitoring and management of risks associated with swap activities. The procedures are required to account for market risk, credit risk, currency risk, legal risk, liquidity risk, settlement risk, operational risk, and any other relevant risks.[162]

Swap dealers and major swap participants must also establish polices for monitoring their traders throughout the day for compliance with trading limits established by the firm. The swap dealers and major swap participants are responsible to ensure that the traders follow the established procedures for executing and confirming transactions. The firms are also responsible for diligent supervision of traders and ensuring that traders remain separate from the risk management unit.[163] "Diligent supervision" is a system in which all activities performed by the partners, members, officers, employees, and agents of a swap dealer or major swap participant are supervised by such entity, and the supervisory system is staffed with qualified supervisory personnel.[164]

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160. *Id.*

161. *Id.* at 9815.

162. Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 Fed. Reg. 20,128, 20,136 (Apr. 3, 2012).

163. *Id.* at 20,143.

164. *Id.*

7. Speculative Position Limit Monitoring

Swap dealers and major swap participants must design procedures to monitor for and prevent violations of applicable speculative position limits established by the CFTC, a DCO, or a SEF. These procedures include:

- Providing annual training for personnel;
- Diligently monitoring and supervising trading;
- Implementing an early warning system;
- Testing position limit procedures;
- Documenting compliance with position limits on a quarterly basis; and
- Auditing the procedures annually.[165]

8. Business Continuity

Swap dealers and major swap participants must establish a business continuity and disaster recovery plan designed to enable them to resume operations by the next business day following an emergency or other disruption.[166]

9. Availability of Disclosure and Inspection

All information required by the CFTC or a prudential regulator must be disclosed by a swap dealer or major swap participant. Adequate internal systems must be developed and deployed in order to promptly provide any required information to the CFTC.[167]

10. Antitrust Restrictions

Swap dealers and major swap participants must adopt policies and procedures to prohibit any action that results in any unreasonable restraint of trade or imposes any material anticompetitive burden on trading or clearing, unless necessary or appropriate to achieve the purposes of the CEA.[168]

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165. *Id.* at 20,142.
166. *Id.* at 20,143.
167. *Id.* at 20,211.
168. *Id.*

11. Qualifications on Research Activities

The CFTC has placed restrictions on the ability of non-research personnel to influence the content of research reports prepared by research analysts employed by a swap dealer, major swap participant, FCM, or introducing broker.[169] In addition, a research analyst cannot be supervised by certain trading and clearing personnel.[170] The rules include the following additional restrictions:

- Compensation for a research analyst may not be based on the contributions of that analyst to the trading or clearing business.[171]
- Favorable research, or threats to change research, may not be given for existing or prospective counterparties by a swap dealer, major swap participant, FCM, or introducing broker in exchange for business or compensation.[172]
- A swap dealer, major swap participant, FCM, or introducing broker may not retaliate against any research analyst who produces a report that may adversely impact the entity's business activities.[173]
- Decisions relating to the provision of clearing services or acceptance of clearing customers may not be influenced in or interfered with by a swap dealer or major swap participant. An appropriate partition must be maintained between business trading personnel and the personnel of an affiliated clearing member.[174]
- No FCM may allow an affiliated swap dealer or major swap participant to interfere with, or attempt to influence, decisions related to the provision of clearing services and activities.[175]

In addition, swap dealers, major swap participants, FCMs, and introducing brokers must disclose whether a research analyst maintains

169. *Id.* at 20,150.
170. *Id.*
171. *Id.* at 20,151.
172. *Id.* at 20,152.
173. *Id.* at 20,211.
174. *Id.* at 20,153.
175. *Id.*

a financial interest in any derivative of a type that the research analyst follows, and the general nature of the financial interest.[176] Research analysts must make the same disclosure when making public appearances.[177]

12. Duties and Qualifications of Executive Officers

A chief compliance officer ("CCO") must have the appropriate background and skills to fulfill his or her responsibilities, and may not be disqualified from registration under the CEA.[178] A CCO is not required to register with the CFTC. However, the CCO must be listed as a principal of the registrant. As with all principals, this requires the submission of a fingerprint card to, and a background investigation by, the NFA.[179]

The CCO must, in consultation with the board of directors or senior officers of the registrant:

- Establish compliance policies;
- Resolve conflicts of interest;
- Take reasonable steps to ensure compliance of the registrant with compliance polices, CEA requirements, and CFTC regulations (the CCO is solely responsible for this duty, and it is not undertaken in consultation with the board of directors or senior officers);
- Identify noncompliance issues; and
- Establish procedures for the remediation of any non-compliance issues.[180]

An annual report is prepared by the CCO containing, among other things: a description of the registrant's compliance with the CEA, CFTC regulations, and the registrant's own compliance policies; an assessment of the effectiveness of the registrant's policies; a discussion of areas for improvement; a description of the resources set aside for compliance; and a description of any non-compliance issues identified and addressed.[181]

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176. *Id.* at 20,152.
177. *Id.*
178. *Id.* at 20,201.
179. *Id.*
180. *Id.*
181. *Id.*

E. Commercial End-User

A "commercial end-user" is a counterparty to a swap that is not a "financial entity" that is using such swaps to hedge or mitigate commercial risk.[182] A financial entity can be a swap dealer, major swap participant, commodity pool, certain private funds, an ERISA plan, and certain banking entities. Commercial end-users are exempt from the major swap participant definition and the related regulatory oversight of major swap participants.

In addition, if a swap is required to be cleared and one party to the swap is a commercial end-user, that party may choose not to clear the swap. Dodd-Frank further provides commercial end-users with the option to choose their clearinghouse or clearing agency and the option to segregate margin with an independent third-party custodian.

F. Derivatives Clearing Organization

To be registered and to maintain registration as a DCO, an extensive set of criteria must be met. Key criteria would require that each DCO must:

- Have adequate financial operational and managerial resources, as determined by the relevant Commission;
- Possess financial resources that, at a minimum, exceed the total amount that would enable the DCO to (a) meet its financial obligations to its members and participants, notwithstanding a default by the member or participant creating the largest financial exposure for the DCO in "extreme but plausible market conditions," and (b) cover the costs of the DCO for a one-year period;
- On an on-going basis, establish and implement procedures to verify the compliance by members and participants with each membership and participation requirement of the DCO;
- Not less than once during each business day, measure the credit exposure of the DCO to each member and participant of the DCO, and monitor each such exposure periodically during the business day of the DCO;

182. *See* Commodity Exchange Act § 2(h)(7)(A), 7 U.S.C. § 2(h)(7)(A) (2006).

- Through margin requirements and other risk control measures, limit the exposure of the DCO to potential losses from default by members and participants of the DCO;
- Have rules and procedures designed to allow for the efficient, fair, and safe management of events in the case of a member or participant insolvency; and
- Establish and enforce rules to minimize conflicts of interest in the decision-making process of the DCO.[183]

G. DEPOSITORY INSTITUTIONS AND "SWAP PUSH-OUT RULE"

A key measure of Dodd-Frank is to remove the implicit U.S. federal guarantee of derivatives trading, in which the Federal Government underwrites the risk inherent in a derivatives portfolio to avoid an even larger economic meltdown. The "Swap Push-Out Rule" prohibits providing "federal assistance" to a depository institution that constitutes a "swaps entity" and also contains several important exemptions for qualifying insured depository institutions.[184] A "swaps entity" is any swap dealer or major swap participant that is registered with the CFTC or SEC, but does not include any major swap participant that is also an insured depository institution.[185] "Swap entity" does not include certain insured depository institutions in conservatorship or receivership.[186]

1. Federal Assistance

"Federal assistance" is defined as the use of any advances from any Federal Reserve credit facility or discount window, or the Federal Deposit Insurance Corporation ("FDIC") insurance or guarantees, for the purpose of:

- Making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity;
- Purchasing the assets of any swaps entity;
- Guaranteeing any loan or debt issuance of any swaps entity; or

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183. Dodd-Frank Act, Pub. L. No. 111–203, § 725, 124 Stat. 1376, 1685 (2010).
184. *Id.* § 716.
185. *Id.* § 716(b)(2).
186. *Id*.

- Entering into any assistance arrangement, loss sharing, or profit sharing with the swaps entity.[187]

2. Exemptions

An FDIC-insured depository institution will not be subject to the prohibition on Federal assistance if its swap activities are limited to:

- Hedging and other similar risk-mitigating activities directly related to the insured depository institution's activities;
- Acting as a swaps entity for swaps involving interest rates or reference assets permissible for investment by a national bank under applicable banking law; and
- Acting as a swaps entity for credit default swaps that are cleared by a DCO or a clearing agency.[188]

3. Affiliated Swaps Entities

Dodd-Frank's prohibition on federal assistance does not apply to an FDIC-insured depository institution establishing and maintaining an affiliate that is a swaps entity, provided that:

- The depository institution is part of a bank holding company or savings and loan holding company that is supervised by the Federal Reserve; and
- The affiliated swaps entity complies with Sections 23A and 23B of the Federal Reserve Act and any other requirements that the CFTC, SEC, and the Federal Reserve may determine are necessary.[189]

4. Effective Date

The Swap Push-Out Rule is scheduled to go into effect in July 2013.[190] If an insured depository institution qualifies as a swaps entity and therefore is ineligible for Federal assistance, the applicable Federal bank regulator may give the institution up to a 24-month transition

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187. *Id*. § 716.
188. *Id*.
189. *Id*.
190. *Id.* § 716(h) ("The prohibition in subsection (a) shall be effective 2 years following the date on which this Act is effective.").

period to divest the swaps entity or cease the activities that require registration as a swaps entity, plus the possibility of a one-year extension.[191]

5. Effect

Insured depository institutions that have entered into swaps before the expiration of the transition period in which the institution must divest itself of the swaps entity do not have to unwind existing swaps to continue to receive Federal assistance.[192]

V. SELECTED REGULATORY CHANGES AFFECTING COMMODITY FUTURES AND OPTIONS

A. INVESTMENT OF CUSTOMER FUNDS HELD IN FUTURES AND OPTIONS ACCOUNTS

Under Section 4d of the CEA,[193] the CFTC has long-standing and extensive rules that govern FCM and DCO-handling of customer assets deposited and/or pledged as collateral for exchange-traded commodity futures contracts, options on commodity futures contracts, and commodity options.[194] Under CFTC Rule 1.25, there are certain, limited "permitted investments" that may be made using customer funds. These investments are subject to various conditions ensuring that such funds are protected through conservative investment.[195]

1. Amendment of CFTC Rules 1.25 and 30.7

The CFTC Division of Clearing and Intermediary Oversight conducted reviews in 2007 after the 2008 market crisis and as required by Title IX of Dodd-Frank. As a result of these reviews, the CFTC determined that CFTC Rules 1.25 and 30.7 should be amended. The CFTC determined that the following investments should be removed from permitted investments under Rule 1.25:

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191. *Id*. § 716.
192. *Id*.
193. Commodity Exchange Act § 4d, 7 U.S.C. § 6d (2006).
194. *See, e.g.*, 17 C.F.R. §§ 1.3(k), (gg), (hh), (jj), (rr), 1.20-1.30, 1.32, 1.68, 30.7 (2012).
195. 17 C.F.R. § 1.25 (2012).

- Corporate debt obligations were found to not be widely used, and in "tumultuous markets," the holding of customer funds in these types of assets could threaten customers' funds.[196]
- Foreign sovereign debt was of concern, because of the recent Eurozone crisis. Although commenters noted that foreign sovereign debt investments were used to mitigate foreign currency risk faced by FCMs when they convert customer funds into foreign currency to meet FX margin requirements, the CFTC decided that the potential volatility in such debt outweighed such considerations. However, the CFTC indicated it would consider certain organizations' requests for exemptive relief under certain circumstances.[197]
- "In-house" transactions had become a concern of the CFTC because of concentrating credit risk within FCMs. The CFTC favors the use of repurchase transactions with unaffiliated third parties. The CFTC expressed concern that in-house transactions lack legal documentation and a mechanism to ensure delivery versus payment, both of which would help protect customer funds.[198]
- Repurchase agreements with FCM affiliates were also a concern, because of potential conflicts of interest among affiliates.[199]

In order to meet the over-arching general standard in CFTC Rule 1.25 that permitted investments be "consistent with the objectives of preserving principal and maintaining liquidity," permitted investments have been required to meet certain standards, including minimum credit ratings and marketability. These conditions were amended to set "clear, prudential standards." Among the changes:

- The removal of credit rating requirements for applicable permitted investments.
- Assets with high credit ratings do not automatically fall within the safe harbor.

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196. Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 76 Fed. Reg. 78,776, 78,778 (Dec. 19, 2011).

197. *Id.* at 78,782.

198. *Id.* at 78,782–83.

199. *Id.* at 78,790.

- The CFTC will import the permitted investment regime found in CFTC Rule 1.25 (as amended) into CFTC Rule 30.7, rather than leaving customer funds only subject to the FCM's general fiduciary obligation.

B. SPECULATIVE POSITION LIMITS

1. Summary

The CFTC adopted on October 18, 2011 a comprehensive set of rules on speculative position limits on exchange-traded futures and options contracts and economically equivalent OTC derivatives referencing 28 individual agricultural, metals, and energy commodities.[200] Traders' futures and options positions in these 28 contracts will be aggregated with their positions in economically equivalent OTC derivatives referencing these contracts.[201]

2. Exclusions

Diversified commodity-index contracts are expressly excluded from the scope of these rules.[202] It will be left to DCMs to set position limits for these contracts and economically equivalent OTC derivatives.[203]

3. Setting Position Limits

Position limits will be set with the following procedure:

- New single month and all-months-combined position limits for futures and options in the "legacy" commodity contracts (agricultural contracts currently subject to CFTC-set limits) are now effective.[204] Other non-spot month limits will go into effect after the CFTC has gathered one year of swap data to inform its limit-setting.
- Spot month position limits will be effective 60 days after the term "swap" is further defined by the CFTC and SEC.

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200. Position Limits for Futures and Swaps, 76 Fed. Reg. 71,625 (Nov. 18, 2011).
201. *Id.* at 71,629.
202. *Id.* at 71,656.
203. *Id.*
204. *Id.* at 71,632.

> At that time, traders' OTC positions (*i.e.*, economically equivalent positions) will be added to and counted with their futures and options positions for spot month position limit purposes.[205]

a. Monthly Limits

Spot month limits will be applied separately for physical delivery contracts and cash-settled contracts in the same commodity for all contracts, except NYMEX Henry Hub Natural Gas which will have more liberal limits for cash-settled contracts. Traders will not be able to net physical delivery contracts against cash-settled contracts.[206]

4. Exemptions

Positions in futures, options, and swaps entered into in good faith prior to the effective date of the rules that exceed position limits will not be considered in violation of the rules.[207]

If a trader uses an independent account controller ("IAC") to disaggregate positions held at the IAC from the trader's own positions, it will now need to file an application to the CFTC for relief to avail itself of the disaggregation exemption.[208]

5. Changes to Previous Reporting and Exemptions

Traders holding futures, options, and economically equivalent OTC positions in the energy (except NYMEX Light Sweet Crude Oil and NYMEX Henry Hub Natural Gas) and metal contracts equal to or greater than 50% of the projected aggregate position limit will be required to report their positions to the CFTC under the new position visibility rule.[209] The position visibility levels for NYMEX Light Sweet Crude Oil and NYMEX Henry Hub Natural Gas will be lower.[210] Position

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205. *Id*.
206. 76 Fed. Reg. 71,626 (Nov. 18, 2011).
207. *Id.* at 71,639.
208. *Id.* at 71,652.
209. *Id.* at 71,658.
210. *Id*. ("[L]evels have been set lower to approximate the point where ten traders, on an annual basis, would be subject to position visibility reporting requirements.").

visibility reporting requirements will go into effect 60 days after the term swap is further defined by the Commissions.[211]

In most cases, swap dealer positions opposite financial entities will no longer qualify as *bona fide* hedging-eligible positions for the swap dealers. This will likely limit the commodity market exposure capacity swap dealers will have available to provide to financial entities.

VI. BLOCK TRADE RULES

On February 23, 2012, the CFTC proposed rules defining criteria for grouping swaps into separate swap categories and establishing methodologies for setting appropriate minimum block trade sizes for each swap category (the "Proposed Block Trading Rules").[212] The CFTC also proposed rules that would prevent the public disclosure of the identities, business transactions, and market positions of swap market participants (the "Proposed Non-Disclosure Rules").

A. MINIMUM BLOCK TRADE SIZES

The CFTC proposed the implementation of the Proposed Block Trading Rules in two phases: (i) an initial period; and (ii) an ongoing basis thereafter.[213] This will allow market participants to better adjust their swap trading strategies, manage risk, implement new technology, and adjust practices in compliance with the rules.

The CFTC will establish initial minimum block trade sizes for each category of swaps within the interest rate, credit, FX, and other commodity asset classes.[214] Interest rate and credit swap thresholds will be based on actual market data that the CFTC has reviewed.[215] The CFTC did not have data regarding FX and other commodity asset classes, and as such will determine the initial minimum block size based on whether the swap or swap category is "economically related" to a futures contract.[216] If the swap is not economically related to a futures contract, such swap would be subject to a time delay and treated as a

211. *Id.* at 71,688.
212. Procedures To Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 77 Fed. Reg. 15,459 (Mar. 15, 2012).
213. *Id*. at 15,466.
214. *See id.* at 15,460.
215. *See id.*
216. *Id*. at 15,485–86.

block trade or large notional off-facility swap. The initial minimum block sizes are proposed to become effective 60 days following the publication of a final rule adopting these provisions in the Federal Register.[217]

The initial period would last for at least one year after a SDR collects data for the CFTC's review for an asset class, as determined by the CFTC.[218] The CFTC proposed that the initial period would expire after publication by the CFTC of its determination of appropriate minimum block sizes after reviewing the data during the initial period.[219] On an ongoing basis, the CFTC would revise the minimum block sizes for swap categories at least once each calendar year.[220]

The CFTC also proposed special rules for: (i) determining minimum block sizes for particular instances, including swaps in the equity asset class; (ii) converting currencies; and (iii) determining whether a swap with optionality qualifies for block trade or large notional off-facility swap treatment.[221]

B. NON-DISCLOSURE PROTECTIONS

The CFTC proposed new rules establishing procedures to protect the identities of swap counterparties and ensure that business transactions and market positions in connection with disclosing publicly reportable swap transactions remain anonymous.[222] The Proposed Non-Disclosure Rules would amend existing CFTC regulations and establish cap sizes for notional and principal amounts that would mask the total size of a swap transaction if it equals or exceeds the appropriate minimum block trade size for a given swap category.[223] The Proposed Non-Disclosure Rules would also provide limits on the release to the public of certain publicly reportable swap transactions in the other commodity asset class with specific delivery or pricing points.[224]

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217. *Id*. at 15,467.
218. *Id.*
219. *Id.*
220. *Id.*
221. *Id.* at 15,520.
222. *Id.* at 15,467.
223. *Id*.
224. *Id*.

VII. PROPOSED CFTC VOLCKER RULE

At its January 2012 Meeting, the CFTC released for public comment a rule proposal ("Proposed CFTC Volcker Rule") implementing Section 619 of Dodd-Frank.[225]

A. SCOPE

The Proposed CFTC Volcker Rule outlines certain prohibitions and limitations on the ability of banking entities and nonbank financial companies supervised by the Federal Reserve to engage in proprietary trading of securities, derivatives, and certain other financial instruments.[226]

Whereas banking entities are prohibited from engaging in such activities, nonbank financial companies supervised by the Federal Reserve would be subject to trading limits and capital charges if they engage in such trading activities.

Banking entities and nonbank financial companies supervised by the Federal Reserve would be limited in their holding of certain interests in, or relationships with, hedge funds and private equity funds (collectively "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 commodity pools and the foreign equivalents of any Covered Funds.

The Proposed CFTC Volcker Rule is largely identical to the joint rule proposal issued by the Federal Reserve, the Office of the Comptroller of the Currency, the FDIC, and the SEC in October 2011 ("Joint Volcker Rule").[227] The CFTC has modified the Joint

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225. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8331 (proposed Feb. 14, 2012).

226. *Id*. at 8332.

227. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (proposed Nov. 11, 2011).

Volcker Rule primarily to the extent necessary to add CFTC-specific provisions. The CFTC has requested comments, including whether certain provisions of the Joint Volcker Rule should apply to CFTC-regulated banking entities.

B. Proposed Requirements

The Proposed CFTC Volcker Rule would establish various requirements for banking entities, including the creation of internal compliance programs to govern their covered trading and Covered Fund activities.[228] The entities' respective regulatory authorities would provide oversight on these compliance programs.

The Proposed CFTC Volcker Rule does not create any enforcement authority for the CFTC. The bank regulators under the Bank Holding Company Act would continue to hold such authority. The Proposed CFTC Volcker Rule also does not cover all banking activities, but only the activities over which the CFTC is the primary regulator.

C. Ramifications

The Proposed CFTC Volcker Rule is expected to impact most directly the operations of the sell-side of the commodity trading market. It is expected to have less impact on the operations of the buy-side, which include most asset managers of mutual funds, private funds, and separately managed accounts.

However, both the sell-side and buy-side find the Proposed CFTC Volcker Rule and Joint Volcker Rule controversial. Because these proposed rules do not currently clarify many activities and restrictions, including the extent to which certain activities will be permitted or prohibited market-making or hedging activities, there is a large amount of uncertainty. The possible restrictions could limit buy-side accessibility to the derivatives markets and liquidity in such markets.

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228. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. at 8426.