Davis Polk

Derivatives Reform: A Work in Progress

2012 Mutual Funds and Investment Management Conference

Susan C. Ervin*
Davis Polk & Wardwell LLP
901 15th Street NW
Washington, DC 20005
susan.ervin@davispolk.com

March 5, 2012

*Jeffrey T. Dinwoodie, an associate at Davis Polk & Wardwell LLP, assisted in the preparation of this outline.

Davis Polk

Contents

I. Types of Regulated Products 1

II. Swap Dealers 4

III. Major Swap Participants 5

IV. Key Consequences of Being a Swap Dealer or Major Swap Participant 6

V. Clearing Requirement 10

VI. Trade Execution Requirement 11

VII. Treatment of Collateral 12

VIII. Reporting Requirements 13

IX. Position Limits 15

X. Key Title VII Terms 16

Introduction

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Title VII**") outlines a comprehensive regulatory framework for swaps and other over-the-counter ("**OTC**") derivatives transactions. Title VII was designed to eliminate the exclusions from regulation created by the Commodity Futures Modernization Act of 2000 and promote four principal objectives:

- transparency of pricing and trading of OTC derivatives, thus enhancing the ability of regulators and market participants to evaluate pricing and trading activity;
- regulation of market participants, trading facilities and transactions;
- counterparty protection; and
- protection against systemic risk.

Today, more than a year and a half after Dodd-Frank was signed into law, implementation of the Title VII framework remains a work in progress. Of the nearly 100 rulemakings required to implement Title VII, fewer than half have been completed. Nonetheless, as the discussion below reflects, the shift to a highly regulated swaps market is moving forward on multiple fronts.

I. Types of Regulated Products

A. Title VII categorizes derivatives transactions within its scope as either "swaps," which are subject to primary regulation by the Commodity Futures Trading Commission ("**CFTC**"), "security-based swaps," which are subject to primary regulation by the Securities and Exchange Commission ("**SEC**"), or "mixed swaps," which are subject to joint regulation by the CFTC and SEC.[1]

B. **Swaps**. Title VII adopts a sweeping definition of the term "swap," which includes, agreements, contracts, and transactions (1) that provide for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence; (2) that provide on an executory basis for the exchange, on a fixed or contingent basis, of one or more payments based on the value or level of one or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, including any agreement, contract, or transaction commonly known as an interest rate swap, a rate floor, a rate cap, a rate collar, a cross-currency rate swap, a basis swap, a currency swap, a foreign exchange swap, a total return swap, an equity index swap, an equity swap, a debt index swap, a debt

[1] For ease of presentation, unless otherwise indicated, the term "swaps" will be used in this outline to refer to both "swaps" and "security-based swaps;" the term "swap dealers" will be used in this outline to refer to both "swap dealers" and "security-based swap dealers;" and the term "major swap participants" will be used in this outline to refer to both "major swap participants" and "major security-based swap participants." Key terms used in Title VII are defined *infra*, in Section X.

swap, a credit spread, a credit default swap, a credit swap, a weather swap, an energy swap, a metal swap, an agricultural swap, an emissions swap, or a commodity swap; and (3) that are options on interest or other rates, currencies, commodities, securities, and other financial or economic interests or property of any kind.

1. **Exclusions**. The definition of "swap" excludes, among other transactions, futures contracts, security-based swaps, sales of a non-financial commodity or security for deferred shipment or delivery that are intended to be physically-settled and any transaction providing for the purchase or sale of one or more securities on a fixed basis that is subject to the Securities Act and the Securities Exchange Act of 1934.

2. **Foreign Exchange Swaps and Forwards**. Title VII provides that foreign exchange swaps and forwards will be considered to be swaps, and regulated as such, unless the Treasury Department makes a written determination that either or both types of transactions (1) should not be regulated as swaps and (2) are not structured to evade the Dodd-Frank Act. Such an exemption does not, however, provide relief from swap reporting and business conduct rules. In April 2011, the Treasury Department issued a proposed determination to exempt both foreign exchange swaps and foreign exchange forwards based upon their settlement on a physical basis, among other factors.[2]

C. **Security-based Swaps**. Security-based swaps are defined to include swaps that are based on (1) a narrow-based security index, (2) a single security or loan, including any interest therein or on the value thereof or (3) the occurrence, nonoccurrence or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition or financial obligations of the issuer.

1. **Exclusions**. The definition of "security-based swap" excludes agreements, contracts or transactions that meet the definition of security-based swap only due to referencing or being based on government securities and certain other "exempted securities" (not including municipal securities). The effect of this is to allocate jurisdiction of swaps on government securities to the CFTC. Options and physically-settled forwards on such securities are not swaps or security-based swaps and therefore are not subject to most provisions of Title VII.

D. **Mixed Swaps**. Title VII defines "mixed swap" as a transaction that meets the definition of "security-based swap" and that is also based on the value of one or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence.

E. **Joint CFTC/SEC Definitional Authority**. Title VII requires the CFTC and SEC, in consultation with the Board of Governors of the Federal Reserve, to jointly further define the terms "swap," "security-based swap," and "security-based swap agreement." Title VII also provides that the CFTC and SEC must jointly adopt regulations regarding "mixed swaps" as may be necessary to carry out the purposes of swap and security-based swap regulation

[2] *See* Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 FR 25774 (May 5, 2011).

under Title VII. In April 2011, the CFTC and SEC proposed joint rules to further define "swap," "security-based swap," and other key terms employed in Title VII.[3]

1. **Transactions That Are Swaps or Security-based Swaps**. The agencies' proposed guidance would clarify the status of certain transactions, including guidance that:
   a. notwithstanding their "forward" label, forward rate agreements will be deemed to be swaps (unless otherwise excluded in the statute); and
   b. options on swaps, forward swaps and certain contracts for differences are swaps or security-based swaps.
2. **Mixed Swaps**. The agencies stated that the scope of the "mixed swap" definition is intended to be narrow and proposed rules for their treatment:
   a. One proposed rule would provide a regulatory framework with which parties to bilateral uncleared mixed swaps, where at least one of the parties is dually registered with both agencies, would need to comply.
   b. A second proposed rule would establish a process for all other mixed swaps, by which persons may request modified regulatory treatment by joint order of the SEC and CFTC.
3. **Insurance**. The proposed rules and interpretive guidance would clarify, among other things, that the following products would not be considered to be swaps or security-based swaps if offered by a regulated insurance company: surety bonds, life insurance, health insurance, long-term care insurance, title insurance, property and casualty insurance, and annuity products the income on which is subject to tax treatment under Section 72 of the Internal Revenue Code.
4. **Security forwards**. The proposed interpretive guidance clarifies that security forwards (sales of securities for deferred shipment or delivery) that are intended to be physically settled would fall outside the definitions of swap and security-based swap.
5. **Forward Exclusion from the Swap Definition for Non-Financial Commodities**. The proposed interpretive guidance would clarify the scope of the statutory forward contract exclusion for non-financial commodities. In particular, the CFTC stated that the forward exclusion should be interpreted in a manner consistent with the CFTC's historical interpretation of the existing forward exclusion with respect to futures contracts; intent to deliver is an essential element of a forward contract and should be evaluated based on the CFTC's established multi-factor approach; and book-out transactions in non-financial commodities that meet the requirements of the Brent Interpretation and that are effected through a subsequent, separately-negotiated transaction should qualify for the forward contract exclusion.[4]

---

[3] *See* Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 FR 29818 (May 23, 2011).

[4] The "Brent Interpretation" refers to the CFTC's 1990 Statutory Interpretation Concerning Forward Transactions, 55 FR 39188 (Sept. 25, 1990), which addressed the applicability of the forward contract exclusion to transactions for the purchase or sale of Brent crude oil commonly known as 15-day Brent contracts. The Brent Interpretation confirmed the CFTC's view that transactions between commercial participants in connection with their business that created specific delivery obligations imposing substantial commercial risks were within the forward contract exclusion, notwithstanding that certain parties in a delivery chain might close out their transactions by cash payment.

6. **Consumer and Commercial Transactions**. The proposed interpretive guidance, citing the agencies' belief that Congress did not intend to subject customary consumer and commercial transactions to the regulatory scheme for swaps or security-based swaps, would clarify that certain consumer and commercial transactions do not fall within the statutory definitions of those terms. For example, transactions to acquire or lease real or personal property and certain other transactions entered into by consumers primarily for personal, family or household purposes would not be considered swaps or security-based swaps.

II. Swap Dealers

A. Title VII defines a "swap dealer" as any person (subject to limited exceptions) who:

1. holds itself out as a dealer in swaps;
2. makes a market in swaps;
3. regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
4. engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

B. Title VII exempts the following entities from the definition of swap dealer:

1. an insured depository institution to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer;
2. 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"; and
3. an entity that engages in a "*de minimis* quantity" of swap dealing in connection with transactions with, or on behalf, of its customers.

C. In December 2010, the CFTC and SEC proposed joint rules further defining the terms "swap dealer" and "major swap participant."[5]

1. Under the agencies' proposal, a person would be required to meet all of the following conditions in order to be exempt from the swap dealer definition on the basis of *de minimis* activity:
   a. the aggregate effective notional amount of the swaps that the person enters into over the prior 12 months does not exceed $100 million;
   b. the aggregate effective notional amount of such swaps with Special Entities[6] over the prior 12 months does not exceed $25 million;

[5] *See* Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant'', 75 FR 80174 (Dec. 21, 2010).

[6] The agencies proposed to use the statutory definition of "Special Entity" in this context, which would include Federal agencies, States, State agencies, cities, counties, municipalities, other political subdivisions of a State, any ERISA Section 3 employee benefit plan or governmental plan, and any endowment.

c. the person does not enter into swaps with more than 15 counterparties, other than swap dealers, over the prior 12 months; and

d. the person has not entered into more than 20 swaps as a dealer over the prior 12 months.

III. Major Swap Participants

A. Title VII defines a "major swap participant" as any person who is not a swap dealer, and

1. maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC and SEC, excluding:

a. positions held for hedging or mitigating commercial risk; and

b. positions maintained by any employee benefit plan … [under ERISA] for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

2. 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; or

3. is a financial entity[7] that is highly leveraged relative to the amount of capital it holds … and maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC and SEC.

B. Under the agencies' December 2010 joint proposal, a non-swap dealer would be a major swap participant if its:

1. current uncollateralized exposure with respect to any category of swap (with hedge offsets for entities that are not highly-leveraged financial entities) is $3 billion for rate swaps or $1 billion for other categories of swaps/security-based swaps; or

2. current uncollateralized exposure plus its potential future exposure with respect to any category of swap (with hedge offsets for entities that are not highly-leveraged financial entities) is $6 billion for rate swaps or $2 billion for other categories of swaps/security-based swaps; or

3. current uncollateralized exposure is $5 billion for swaps, or in the case of major security-based swap participants, $2 billion for security-based swaps; or

4. current uncollateralized exposure plus its potential future exposure is $8 billion for swaps, or in the case of major security-based swap participants, $4 billion for security-based swaps.

[7] Under the agencies' December 2010 joint proposal, "financial entity" would be defined as a swap dealer; major swap participant; commodity pool; private fund; employee benefit plan; or person predominantly engaged in the business of banking or in activities that are financial in nature.

IV. Key Consequences of Being a Swap Dealer or Major Swap Participant

A. Registration. Title VII requires swap dealers and major swap participants to register with the CFTC and security-based swap dealers and major security-based swap participants to register with the SEC.

1. In January 2012, the CFTC finalized rules concerning the registration procedures for swap dealers and major swap participants.[8]
   a. The procedures are based upon the existing registration scheme in place for other CFTC registrants, such as futures commission merchants ("**FCMs**").
   b. Swap dealers and major swap participants must register by filing with the National Futures Association ("**NFA**") a Form 7-R as well as Form 8-R and fingerprint cards on behalf of its principals.
   c. Applicants must submit to the NFA any documentation that may be required to demonstrate their compliance and ability to comply with the capital and margin, reporting and recordkeeping, external business conduct standards, documentation standards, internal business conduct standards (e.g., conflicts of interest, risk management), chief compliance officer, and segregation regulations for swap dealers and major swap participants that are in effect at the time of application.
2. In October 2011, the SEC proposed rules concerning the registration procedures for security-based swap dealers and major security-based swap participants.[9]
   a. The procedures would be based upon on the existing registration scheme in place for broker-dealers.
   b. Security-based swap dealers and major security-based swap participants would register with the SEC by electronically filing a new form, Form SBSE.
   c. Security-based swap dealers and major security-based swap participants would be required to, among other things, have a knowledgeable senior officer provide a certification as to the firm's financial, operational and compliance capabilities to the SEC.

B. Capital and Margin Requirements. Title VII imposes capital and, for uncleared swaps, initial and variation margin requirements on swap dealers and major swap participants.

1. Title VII requires swap dealers and major swap participants for which there is a prudential regulator to meet the capital and margin requirements established by the applicable prudential regulator, and each swap dealer and major swap participant for which there is no prudential regulator to comply with the capital and uncleared swap margin requirements established by the CFTC and SEC.
2. In April 2011, the CFTC proposed rules governing margin requirements for uncleared swaps entered into by non-bank swap dealers and major swap participants.[10]

---

[8] *See* Registration of Swap Dealers and Major Swap Participants, 77 FR 2613 (Jan. 19, 2012).

[9] *See* Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 76 FR 65784 (Oct. 24, 2011).

[10] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (Apr. 28, 2011).

a. For swaps between swap dealers/major swap participants and other swap dealers/major swap participants, the proposed rules would require bilateral initial and variation margin for each trade. For swaps between swap dealers/major swap participants and financial entities, the rules would require the swap dealer/major swap participant to collect, but not pay, initial and variation margin for each transaction, subject to permissible thresholds[11] for financial entities that (1) are subject to capital requirements established by a prudential regulator or a State insurance regulator; (2) do not have significant swaps exposure; and (3) are using their uncleared swaps to hedge or mitigate risks of their business activities.

b. The proposed rules would not require swap dealers/major swap participants to pay or collect initial or variation margin from non-financial entities. However, swap dealers/major swap participants would be required to execute documentation regarding credit support arrangements with each counterparty.

3. In April 2011, the CFTC proposed capital requirements for swap dealers and major swap participants that are not subject to prudential regulation.[12]

a. The proposed rules address the swap dealer's or major swap participant's qualifying capital and the minimum levels of such qualifying capital that the swap dealer or major swap participant would be required to maintain.

b. Under the proposed rules, a swap dealer or major swap participant may apply for CFTC approval to use internal models for purposes of its capital calculations.

c. The proposed rules also include financial condition reporting and related recordkeeping requirements for swap dealers and major swap participants.

4. The SEC has not yet proposed capital or margin requirements for security-based swap entities.

C. Business Conduct Standards. Title VII requires swap dealers and major swap participants to comply with business conduct standards adopted by the CFTC and SEC.

1. In January 2012, the CFTC finalized external business conduct standards for swap dealers and major swap participants.[13] Key aspects of the rule include the following:

a. Swap dealers must implement "know your counterparty" policies and procedures that are designed to obtain essential facts about a counterparty whose identity is known to the swap dealer prior to execution.

b. Swap dealers and major swap participants are prohibited from disclosing any material confidential information provided by a counterparty and from using such information for their own purposes in a way that would be materially adverse to that counterparty's interests.

c. Swap dealers must offer to provide those counterparties that are not swap dealers, major swap participants, security-based swap dealers, or major security-based swap participants ("**non-swap entities**") with a scenario analysis prior to entering into a

[11] The CFTC proposed a range of alternatives for the initial margin and variation margin thresholds.

[12] *See* Capital Requirements for Swap Dealers and Major Swap Participants, 76 FR 27802 (May 12, 2011).

[13] *See* Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 FR 9734 (Feb. 17, 2012).

swap not made available for trading by a designated contract market ("**DCM**") or swap execution facility ("**SEF**").

d. Swap dealers and major swap participants are required, among other things, to:

(1) verify that a counterparty is an eligible contract participant ("**ECP**") and whether a counterparty is a Special Entity; and

(2) for many swaps,[14] disclose to non-swap entity counterparties:

(i) the material risks of the swap;

(ii) the material characteristics of the swap; and

(iii) the swap dealer's or major swap participant's material incentives and conflicts of interest with respect to the swap;

(3) facilitate a non-swap entity counterparty's access to a swap's daily mark:

(i) for a cleared swap with a non-swap entity, the swap dealer or major swap participant must notify the counterparty of its right to receive the swap's daily mark from the derivatives clearing organization ("**DCO**"); and

(ii) for an uncleared swap with a non-swap entity, the swap dealer or major swap participant must provide the counterparty with the swap's daily mark and the methodologies and assumptions used in calculating the mark, along with specified disclaimers; and

(4) inform a non-swap entity counterparty of its rights with respect to clearing decisions:

(i) for a swap with a non-swap entity subject to mandatory clearing, the swap dealer or major swap participant must notify the counterparty of its right to select the DCO; and

(ii) for a swap with a non-swap entity not subject to mandatory clearing, the swap dealer or major swap participant must notify the counterparty of its right to require clearing and to select the DCO.

e. Swap dealers acting as "advisors" to Special Entities are required to act in the best interests of the Special Entity.

(1) The CFTC adopted two safe harbors that are designed to provide swap dealers with some certainty as to when they would not be deemed to be acting in an advisory role.

(2) The CFTC defined "Special Entity" as a federal agency; a state, state agency, city, county, municipality, or other political subdivision of a state, or any instrumentality, department, or a corporation of or established by a state or political subdivision of a state; any employee benefit plan subject to Title I of ERISA; any governmental plan, as defined in Section 3 of ERISA; or any endowment, including an organization described in Internal Revenue Code Section 501(c)(3), but only where the endowment itself is a counterparty. In

[14] These requirements do not apply to a transaction that is both (a) initiated on a DCM or SEF and (b) one in which the swap dealer/major swap participant does not know the identity of the counterparty prior to the execution.

addition, any employee benefit plan "defined in" Section 3 of ERISA but not "subject to" ERISA or otherwise defined as a Special Entity (e.g., certain church plans), may elect to be a Special Entity by notifying a swap dealer or major swap participant of its election prior to entering into a swap with the particular swap dealer or major swap participant.

f. Swap dealers and major swap participants acting as counterparties to Special Entities are required to, among other things, have a reasonable basis to believe that the Special Entity has a representative that meets certain criteria (or an ERISA fiduciary in the case of an ERISA plan Special Entity).[15]

g. Swap dealers are subject to pay-to-play restrictions. For example, subject to certain *de minimis* and other exceptions, the rule prohibits any swap dealer from offering to enter or entering into a swap, or trading strategy involving a swap, with governmental Special Entities where the swap dealer or any covered associate of the swap dealer has made a contribution to an official of that entity within the prior two years.

2. In June 2011, the SEC proposed external business conduct standards for security-based swap dealers and major security-based swap participants.[16] While the CFTC's final external business conduct standards for swap dealers and major swap participants are similar in certain respects to the SEC's proposed external business conduct standards for security-based swap dealers and major security-based swap participants, there are many differences. For example, the SEC proposed no scenario analysis requirements for security-based swap dealers. In addition, the SEC's proposal contained no requirements relating to the confidentiality of counterparty information.

3. In February 2012, the CFTC finalized internal business conduct standards for swap dealers and major swap participants.[17] Among other things, the rules:

a. impose comprehensive reporting and recordkeeping obligations on swap dealers and major swap participants with respect to their swaps business and related transactions;

b. require swap dealers and major swap participants to establish robust risk management systems, monitor trading to prevent violations of applicable position limits, and establish a business continuity and disaster recovery plan;

c. require swap dealers, major swap participants, and FCMs to designate a chief compliance officer who would be responsible for, among other things:

(1) establishing compliance policies;

(2) resolving conflicts of interest;

(3) taking reasonable steps to ensure compliance with the compliance policies, Commodity Exchange Act requirements, and CFTC rules;

---

[15] These requirements do not apply to a transaction that is both (a) initiated on a SEF or DCM and (b) one in which the swap dealer/major swap participant does not know the identity of the counterparty prior to the execution.

[16] *See* Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 76 FR 42396 (July 18, 2011).

[17] *See* Swap Dealer and Major Swap Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant, and Futures Commission Merchant Chief Compliance Officer, *Federal Register* publication forthcoming.

(4) identifying noncompliance issues; and

(5) preparing an annual report that would contain, among other things, a description of the entity's compliance with its compliance policies, Commodity Exchange Act requirements, and CFTC rules, an assessment of the effectiveness of the entity's policies, and a description of any non-compliance issues identified and addressed; and

d. establish conflicts of interest requirements for swap dealers, major swap participants, FCMs, and introducing brokers, which among other things:

(1) prohibit swap dealers and major swap participants from interfering with or attempting to influence decisions related to the provision of clearing or the acceptance of clearing customers;

(2) prohibit FCMs from permitting any affiliated swap dealer or major swap participant to directly or indirectly interfere with, or attempt to influence, the decision of the clearing unit personnel of the FCM to provide clearing services and activities to a customer;

(3) prohibit swap dealers, major swap participants, FCMs, and introducing brokers from offering favorable research, or threatening to change research, for existing or prospective counterparties in exchange for business or compensation; and

(4) require swap dealers, major swap participants, FCMs, and introducing brokers to disclose whether a research analyst maintains a financial interest in any derivative of a type that the research analyst follows, and the general nature of the financial interest.

V. Clearing Requirement

A. Mandatory Clearing. Title VII mandates that swaps must be cleared through a derivatives clearing organization if they are of a type that the relevant agency determines must be cleared, unless an exemption applies.

1. The CFTC and SEC are required, on an ongoing basis, to review swaps to determine if they should be required to be cleared, and to provide a public comment period regarding any such determination.

2. Clearing organizations must submit to the CFTC or SEC, as appropriate, any swap they plan to accept for clearing and to provide notice to their members of the submission. The CFTC and SEC are required to publish the submissions for comment and, unless the submitting clearing organization agrees to an extension, make a determination as to whether the instrument must be cleared within 90 days of receipt of the submission.

3. Statutory factors for determining whether a swap must be cleared include outstanding exposures, liquidity, pricing data, clearing infrastructure, systemic risk implications, impact on competition, and legal certainty concerning bankruptcy issues.

B. In July 2011, the CFTC finalized its rules governing review of swaps for mandatory clearing.[18] In December 2010, the SEC proposed rules establishing the process for review of security-based swaps for mandatory clearing.[19]

C. **Commercial End-User Exception to the Clearing Requirement**. The commercial end-user exception to the clearing requirement is available to any swap counterparty that:

1. is not a financial entity (a swap dealer; major swap participant; commodity pool; private fund; employee benefit plan; or person predominantly engaged in the business of banking or in activities that are financial in nature);
2. is using the swap to hedge or mitigate commercial risk; and
3. notifies the CFTC or SEC how it generally meets its financial obligations associated with entering into non-cleared swaps.

D. In December 2010, the CFTC[20] and SEC[21] separately proposed rules to implement the end-user exception.

VI. Trade Execution Requirement

A. **Trade Execution Requirement**. Title VII requires that the execution of all swap transactions subject to the clearing requirement occur on a DCM or SEF (or in the case of security-based swap transactions, a securities exchange or security-based swap execution facility ("**SB SEF**")). The mandatory trade execution requirement does not apply if no DCM or SEF (or in the case of a security-based swap, no exchange or SB SEF) makes the swap "available to trade" or if the swap is subject to the end-user exception to the clearing requirement.

B. In December 2011, the CFTC proposed rules to establish a process for DCMs and SEFs to make a swap "available to trade."[22] Under the CFTC proposal, to make a swap available to trade, a DCM or SEF would consider, as appropriate, the following factors with respect to such swap:

1. whether there are ready and willing buyers and sellers;
2. the frequency or size of transactions on DCMs, SEFs, or of bilateral transactions;
3. the trading volume on DCMs, SEFs, or of bilateral transactions;
4. the number and type of market participants;
5. the bid/ask spread;
6. the usual number of resting firm or indicative bids and offers;

---

[18] *See* Process for Review of Swaps for Mandatory Clearing, 76 FR 44464 (July 26, 2011).

[19] *See* Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b–4 and Form 19b–4 Applicable to All Self-Regulatory Organizations, 75 FR 82490 (Dec. 30, 2010).

[20] *See* End-User Exception to Mandatory Clearing of Swaps, 75 FR 80747 (Dec. 23, 2010).

[21] *See* End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 FR 79992 (Dec. 21, 2010).

[22] *See* Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available To Trade, 76 FR 77728 (Dec. 14, 2011).

7. whether a DCM's trading facility or a SEF's trading system or platform will support trading in the swap; or

8. any other factor that the DCM or SEF may consider relevant.

C. Under the CFTC's December 2011 proposal, if a DCM or SEF makes a swap available to trade, all other DCMs and SEFs listing or offering for trading such swap[23] and/or any economically equivalent swap would be required to make those swaps available to trade for purposes of the trade execution requirement. In addition, DCMs and SEFs would be required to conduct an annual review and assessment of each swap they have made available to trade to determine whether or not each swap should continue to be available to trade.

D. The SEC has not proposed standards pursuant to which a determination whether a security-based swap is "available to trade" would be made.

VII. Treatment of Collateral

A. In January 2012, the CFTC finalized rules on the treatment of cleared swap customer collateral.[24] The CFTC adopted the "legal segregation, operational commingling" ("**LSOC**") model, which is designed to provide greater protection of customer collateral than the existing futures model.

1. The LSOC model is designed to eliminate the "fellow customer risk" to which futures customers are exposed. Under the LSOC model, if a customer of an FCM defaults on a cleared swap margin obligation and the FCM is not able to satisfy the defaulting customer's obligations, the DCO has no recourse to funds of the FCM's non-defaulting customers to satisfy the defaulting customer's obligations.

2. Collateral must be invested in accordance with CFTC Rule 1.25, which limits such investments to U.S. government, state and municipal securities; U.S. agency obligations; bank certificates of deposit; certain U.S.-guaranteed commercial paper, corporate notes and bonds; and interests in money market funds, subject to concentration limits and other conditions.

3. In contrast, under the futures model, upon a default of both the FCM and one of its futures customers, the property of non-defaulting customers can be used to satisfy the defaulting customer's obligations. The CFTC has not extended the LSOC model to futures at this time, but has undertaken a review of potential alternatives to the current futures model.

B. In November 2010, the CFTC proposed rules on the treatment of uncleared swap counterparty collateral.[25]

---

[23] The mere listing or trading of a swap on a DCM or SEF would not mean that the swap is available to trade. The proposed procedures to make a swap available to trade are different from the procedures to list a swap for trading under the certification and approval procedures under CFTC Rules 40.2 and 40.3.

[24] *See* Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 FR 6336 (Feb. 7, 2012).

[25] *See* Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 75 FR 75432 (Dec. 3, 2010).

1. Title VII requires swap dealers and major swap participants to notify their counterparties that such counterparties have a right to require that any initial margin which they post to guarantee uncleared swaps be segregated at an independent custodian.
2. The CFTC's proposed rules address a counterparty's right to require segregation and the requirements for segregated accounts. If a counterparty elects segregation for its initial margin, the account would be required to be held at a custodian that is independent of both the counterparty and the swap dealer or major swap participant.
3. Segregated initial margin would be subject to the investment restrictions set forth in CFTC Rule 1.25.

VIII. Reporting Requirements

A. In July 2011, the CFTC finalized large trader reporting rules for physical commodity swaps and swaptions.[26]

1. The rules apply to swaps and swaptions that are linked, or priced at a differential, to either the price of any of the 46 physical commodity futures contracts specified by the CFTC ("**covered futures contracts**") or the price of the same physical commodity on which the covered futures contract is based.
2. The rules require regular position reporting and recordkeeping by clearing organizations, clearing members, and swap dealers for any principal or counterparty accounts that hold physical commodity swaps or swaptions that meet or exceed the "reportable position" threshold set by the CFTC.
3. Special call reporting and recordkeeping requirements also apply to persons with positions in physical commodity swaps or swaptions that exceed a minimum threshold that is lower than the "reportable position" threshold.
4. The rules became effective on September 20, 2011. By letter issued September 16, 2011, the CFTC's Division of Market Oversight granted relief to clearing organizations and clearing members as a class from the large trader reporting of physical commodity swaps until November 21, 2011 for cleared swaps, and January 20, 2012 for uncleared swaps.[27] On November 18, 2011, the Division of Market Oversight issued a second letter to establish a safe harbor for less than fully compliant reporting until March 20, 2012.[28]

B. In December 2012, the CFTC adopted two reporting rules, a swap data reporting rule[29] and a real-time reporting rule.[30] The rules require market participants to report swap transaction

---

[26] *See* Large Trader Reporting for Physical Commodity Swaps, 76 FR 43851 (July 22, 2011).

[27] Letter from Richard A. Shilts, Director, Division of Market Oversight, CFTC, re Temporary and Conditional Relief from the Requirements of §§ 20.3 and 20.4 of the Commission's Regulations Regarding Large Swaps Trader Reporting for Physical Commodities (Sept. 16, 2011).

[28] Letter from Richard A. Shilts, Director, Division of Market Oversight, CFTC, re Temporary and Conditional Relief from the Requirements of §§ 20.3 and 20.4 of the Commission's Regulations Regarding Large Swaps Trader Reporting for Physical Commodities (Nov. 18, 2011).

[29] *See* Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136 (Jan. 12, 2012).

[30] *See* Real-Time Public Reporting of Swap Transaction Data, 77 FR 1182 (Jan. 9, 2012).

information upon execution or shortly thereafter to a swap data repository ("**SDR**"), which is then responsible for disseminating a portion of that information to the public. The methods by which the swap information is reported to the SDR and the time allotted for such reporting depend on the counterparties to the swap, the type of the swap and whether the swap is large enough to qualify as a block trade or large notional off-facility swap. Key aspects of the rules include the following:

1. For swaps executed on or pursuant to the rules of a SEF or DCM, the SEF or DCM is responsible for reporting "swap transaction and pricing information" (time and date of execution, effective and end dates, etc.) and "swap creation data" (the swap's primary economic terms and confirmation data) to the SDR.
2. For off-facility swaps, a designated "reporting counterparty," which differs depending on the status of the counterparties to the swap, is responsible for reporting:
    a. If only one party is a swap dealer or major swap participant, that party is the reporting counterparty.
    b. If one party is a swap dealer and the other party is a major swap participant, the swap dealer is the reporting party.
    c. Otherwise, the parties will designate which party will be responsible for reporting.
3. SDRs are obligated to publicly disseminate swap transaction and pricing information as soon as technologically practicable after receipt, subject to time delays for block or large notional off-facility swaps.
4. Reporting counterparties are also required to report "swap creation data" to SDRs. Swap creation data consists of a swap's primary economic terms (e.g., identity of counterparties, time and date of execution, effective and end dates, etc.) and confirmation data (all of the terms agreed to at confirmation). Primary economic terms and confirmation data must be reported "as soon as technologically practicable" after execution and confirmation, respectively, but no later than within separate varying reporting windows.
5. Swap "continuation data" (a daily snapshot of the primary economic terms of the swap or life cycle event reports) must be reported on an ongoing basis to the same SDR to which the swap was initially reported. Market participants may choose to provide a daily "snapshot" of the primary economic terms of the swap or, instead, to report upon any "life cycle event" – any event that would change the swap's primary economic terms (e.g., assignments and novations).
6. The rules also require market participants to maintain records concerning swaps and to ensure the timely retrievability of records. SEFs, DCMs, DCOs, swap dealers, major swap participants, and non-swap dealer/major swap participant counterparties must keep records throughout the existence of a swap and for five years following termination of the swap. SDRs must keep records throughout the existence of the swap and for 15 years following termination of the swap.

C. In February 2012, the CFTC reproposed procedures to establish appropriate minimum block sizes for large notional off-facility swaps and block trades.[31] The reproposal would, among other things:

1. define the criteria for grouping swaps into separate swap categories that would be subject to a common appropriate minimum block size;
2. establish methodologies for setting appropriate minimum block sizes for each category;
3. implement a two-period, phased-in approach for setting appropriate minimum block sizes for block trades and large notional off-facility swaps; and
4. seek to prevent the public disclosure of the identities, business transactions and market positions of swap market participants by, for example, amending existing CFTC regulations to 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 size for a given swap category.

D. In November 2010, the SEC proposed rules regarding the reporting and public dissemination of security-based swaps.[32]

IX. Position Limits

A. In October 2011, the CFTC finalized rules that establish federal position limits for 28 physical commodity futures and option contracts on exempt (metals and energy) and agricultural commodities and economically equivalent physical commodity swaps.[33] Key aspects of the rules include the following:

1. The position limit levels set the maximum amount of a referenced contract a trader may own or control separately or in combination, net long or short, for both spot and non-spot months.
2. Position limits apply to all "positions in accounts for which any person, by power of attorney or otherwise, directly or indirectly holds positions or controls trading and to positions held by two or more persons acting pursuant to an expressed or implied agreement or understanding."
3. Contracts on diversified commodity indexes are not covered by the new position limits. A contract on an index based on the price of a single commodity may be covered, depending on the underlying commodity.
4. A person must aggregate all positions or accounts in which the person has a 10% or greater ownership interest, as well as accounts over which the person controls trading.
    a. The CFTC retained the "independent account controller" exemption from the aggregation requirement.

[31] *See* Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, *Federal Register* publication forthcoming.

[32] *See* Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 75 FR 75208 (Dec. 2, 2010).

[33] *See* Position Limits for Futures and Swaps, 76 FR 71626 (Nov. 18, 2011).

5. The rules establish a new definition of bona fide hedging transactions, which are exempt from position limits. For a position or transaction to qualify as a bona fide hedge, it must meet the general criteria for a hedging transaction and be one of eight types of enumerated hedging transactions or positions or qualify as a "pass-through swap" or positions taken in connection with a pass-through swap.
    a. The general criteria for a bona fide hedging transaction are that a transaction or position must represent a substitute for a transaction in a "physical marketing channel" made or to be made that is economically appropriate to reduce risk in the conduct of a commercial enterprise and that arises from the change in value of specified assets, liabilities, or services.
    b. The final rule provides for eight types of enumerated hedging transactions. These include, among others, transactions designed to offset positions, or sales of positions, in physical commodities, anticipated merchandising hedges, anticipated royalty hedges, service hedges, and cross-commodity hedges.
    c. A swap, if it is entered into with a counterparty for whom the transaction would qualify as a bona fide hedge (a "**pass-through swap**"), would be deemed to be a bona fide hedge, but only to the extent that the pass-through swap is itself hedged by positions in referenced contracts. Positions or transactions in referenced contracts to hedge a pass-through swap would also be deemed bona fide hedges. A person relying on these provisions to exceed a position limit must obtain a written representation from its counterparty that the swap qualifies in good faith as a bona fide hedging transaction under the rules applicable to the counterparty.
6. The position limits apply on an intraday basis, not merely at the end of each trading day.
7. Pre-existing positions, entered into in good faith, are not subject to position limits, except spot-month limits.
8. The rules establish additional compliance and reporting requirements, including reporting requirements upon exceeding position limit levels and filing and reporting requirements in connection with claiming aggregation and bona fide hedging exemptions.

X. Key Title VII Terms

A. **Derivatives Clearing Organization ("DCO")**. A registered entity that performs several functions, including acceptance of transactions for clearing, daily reconciliation of transactions, daily settlements, and guarantee of financial obligations by the use of initial collateral and daily variation margin.

B. **Designated Contract Market ("DCM")**. A regulated market for commodity futures and options that was expanded under the Dodd-Frank Act to include swaps.

C. **Eligible Contract Participant ("ECP")**. Title VII provides that only ECPs may engage in swaps in private, bilateral, off-exchange transactions. ECPs are not required to transact swaps on a registered exchange. An ECP includes:
    1. government entities that own or invest at least $50 million on a discretionary basis;
    2. individuals that invest at least $10 million on a discretionary basis; and
    3. entities, including corporations, partnerships, organizations or trusts, that have total assets exceeding $10 million or that have a net worth exceeding $1 million and enter into

a swap in connection with the entity's management of the risk associated with an asset or liability.

D. **Legal Segregation, Operational Commingling ("LSOC")**. A model that potentially removes the risk that initial margin could be utilized in a bankruptcy by the FCM for other purposes. Under the LSOC model, if a customer of an FCM defaults on a cleared swap margin obligation and the FCM is not able to satisfy the defaulting customer's obligations, the derivatives clearing organization has no recourse to funds of the FCM's non-defaulting customers.

E. **Major Swap Participants**. Newly defined category of registered entities that are not swap dealers but have significant positions in swaps that could pose systemic danger. Title VII requires the SEC and CFTC to clarify the scope and reach of the definitions of major swap participant and major security-based swap participant through regulation.

F. **Swap Data Repositories ("SDRs")**. Registered entities that are generally responsible for receiving, processing and maintaining (more or less warehousing) swap transaction data.

G. **Swap Dealers**. Newly defined category of registered entities that includes any person that "regularly enters into swaps with counterparties as an ordinary course of business for its own account," in addition to persons that hold themselves out as dealers or who make a market in swaps. Title VII excludes from the dealer category entities that engage in only a *de minimis* amount of swap dealing activity or that enter into swaps for their own account, but not as part of a regular business. Title VII requires the CFTC and SEC to adopt regulations to further define key terms for swap dealer definitions.

H. **Swap Execution Facilities ("SEFs")**. Registered entities required to operate electronic trading platforms that permit multiple participants to interact with multiple other participants with impartial access. The SEF will allow participants to post and view firm and indicative quotes on a centralized electronic format.