

June 20, 2011

CFTC, SEC Provide Dodd-Frank Relief for Effective Date Concerns

Executive Summary

With the July 16 general effective date for derivatives provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) fast approaching and the vast majority of required swap rulemakings still unfinished, the Commodity Futures Trading Commission and the Securities and Exchange Commission have each taken action to provide extensive (albeit temporary) exemptive relief for derivatives market participants that is intended to enable them to preserve the status quo for their derivatives business until the full “mosaic” of the new regulatory regime is in place. The CFTC action is a proposed exemptive order that was published on June 17, with a July 1 deadline for public comments, to ensure that it is in final form before July 16. The primary SEC action takes the form of a final exemptive order dealing with effective date issues; the SEC has additionally proposed to exempt cleared security-based swap agreements from certain of the registration requirements under the federal securities laws.

The July 16 Deadline

Under Sections 754 and 774 of Dodd-Frank, the provisions of the Dodd-Frank that do not have an explicit effective date will come into effect on the later of

- the 360th day after the date of enactment, or
- not less than 60 days after publication of the relevant final rule if the Dodd-Frank provision in question requires rulemaking for implementation.

The key factor in determining which leg of the effective-date test applies to a particular Dodd-Frank provision, therefore, is whether the provision “requires” a rulemaking for implementation. (The SEC and CFTC refer to provisions that do not require a rulemaking as “self-effectuating.”) The primary source of concern regarding the effective date has been the difficulty of applying that standard to the many provisions of the statute that do not explicitly require implementing rules but that are nevertheless inextricably intertwined with related rulemakings, none of which are expected to be completed by July 16. The dilemma for market participants has been to identify those provisions that will be deemed to be self-effectuating and those that will be deemed to require further rulemaking.

The Regulators’ Response

The CFTC and SEC have now proposed to allow the derivatives business to continue as usual after July 16 by 1) explicitly identifying the Dodd-Frank provisions that will become effective on July 16, and 2) exempting market participants and transactions from compliance with applicable provisions of the securities and commodities laws amended by

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Dodd-Frank until the relevant rulemakings are final (in the case of the SEC) or until the earlier of December 31, 2011, or the date on which the relevant rulemakings are final (in the case of the CFTC).

The CFTC Proposed Order

The proposed CFTC exemptive order for swaps was issued on June 14 under the general exemptive authority of Commodity Exchange Act (CEA) Section 4(c)(1). The CFTC proposal, which describes the scope of the proposed exemptive relief but does not include the actual text of the proposed order, groups the derivatives provisions of Dodd-Frank as to which the CFTC has regulatory responsibility into four broad categories:

1. provisions that, by their terms, do not take effect without the adoption of implementing rules;
2. self-effectuating provisions that include references to terms that require further definition;
3. self-effectuating provisions that do not reference terms requiring further definition and that repeal current provisions of the CEA; and
4. other self-effectuating provisions.

The CFTC's proposed exemptive order would provide relief for Categories 2 and 3 above and has 2 parts:

- Part 1 deals with provisions that are linked to unfinished definitions by exempting derivatives market participants from compliance with any provision of the CEA added by the Dodd-Frank that references one or more of the following new terms: swap, swap dealer, major swap participant and eligible contract participant—i.e., Category 2 provisions. Thus, for example, the requirement that any person who holds customer collateral deposited to margin cleared swaps be registered with the CFTC as a futures commission merchant and hold such collateral in segregated accounts will not take effect on July 16.
- Part 2 deals with self-effectuating provisions that do not reference the new statutory terms (i.e., Category 3 provisions) by expanding the availability of the derivatives exemption in Part 35 of the CFTC's regulations. That exemption, which historically has applied to over-the-counter transactions that are not effected on a multilateral transaction execution facility and meet certain other tests, would be expanded by the CFTC order on a temporary basis to replace the CEA exemptions for swaps and other transactions that are being repealed, effective July 16. Specifically, the CFTC will exempt a transaction in exempt or excluded commodities from the CEA, notwithstanding that: (i) the transaction may be executed on a multilateral transaction execution facility; (ii) the transaction may be cleared; (iii) persons offering or entering into the transaction may be eligible contract participants as defined in the CEA prior to July 16; and/or (iv) no more than one of the parties to the transaction is entering into the transaction in connection with its line of business.

The Proposed Order does not deal with questions relating to the potential extraterritorial scope of the CFTC's jurisdiction. Moreover, the CFTC may not use Section 4(c) to grant exemptions from certain provisions of the CEA, including the provisions that require (i) swap dealers to segregate uncleared swaps collateral upon request; (ii) clearing organizations that clear swaps to be registered with the CFTC; and (iii) requiring swap dealers and major swap participants to designate a chief compliance officer. CFTC staff is, however, considering adopting a no-action position that would provide relief from these provisions similar to the Proposed Order.

The remaining provisions will take effect either on July 16, 2011 (in the case of Category 4 provisions) or upon the effective date of the applicable final implementing rules, which can be no earlier than 60 days following their adoption (in the case of Category 1 provisions). The text of the Federal Register release describing the proposed CFTC order is available at <http://www.gpo.gov/fdsys/pkg/FR-2011-06-17/pdf/2011-15195.pdf>. Charts identifying the Dodd-Frank provisions that fall within Category 1 and Category 4 are available at http://www.cftc.gov/PressRoom/Events/opaevent_cftcdoddfranko61411.html.

The SEC Exemptive Order

The primary SEC exemptive order (the "SEC Order") for security-based swaps was issued in final form on June 15 under the authority of Section 36 of the Securities Exchange Act of 1934 (Exchange Act), which permits the SEC to exempt persons from applicable provisions of the Exchange Act. (The text of the SEC Order is available at <http://www.sec.gov/rules/exorders/2011/34-64678.pdf>.)

The SEC Order sets forth the security-based swap provisions of Dodd-Frank, identifies those provisions that will become effective on July 16, and provides an exemption from compliance with most of those provisions. Among other things, the SEC Order (i)

exempts persons from reporting pre-enactment security-based swaps until six months after a security-based swap data repository has been registered with the SEC; (ii) exempts security-based swap execution facilities (SB SEFs) from registration until the earliest compliance date established in final rules adopted by the SEC; (iii) exempts registered securities clearing agencies from the requirement that they appoint a chief compliance officer until the compliance date that will be established by the SEC; and (iv) exempts security-based swap dealers and major swap participants from the requirement that they segregate initial margin posted by their counterparties in uncleared security-based swap transactions until the registration rules for such entities become effective.

The SEC Order does not apply to the security-based swap provisions of Dodd-Frank that will not become effective on July 16 because they require a rulemaking or apply only to registered persons for whom the registration process has not yet been finalized. Thus, for example, the SEC Order does not contain provisions exempting persons that may be security-based swap dealers or major swap participants from registration because the final rules that would implement these registration requirements are still pending.

The Proposed SEC Rules

The SEC has separately proposed rules under the Securities Act of 1933 and the Exchange Act (Proposed SEC Rules) that would exempt security-based swaps that are cleared by central counterparties from certain of the requirements that would otherwise under those statutes. (The text of the Proposed SEC Rules is available at <http://www.sec.gov/rules/proposed/2011/33-9222.pdf>.) In particular, the Proposed SEC Rules would exempt transactions in security-based swaps between eligible contract participants that are cleared by clearing agencies that act as the central counterparty to these transactions from all provisions of the Securities Act other than the anti-fraud provisions. This proposed exemption is similar to the current Securities Act exemptions for security futures products and certain standardized securities options. The Proposed SEC Rules also would effectively permit a broker or dealer to effect a transaction in a cleared security-based swap on a national securities exchange without requiring such swap to be registered for trading on that exchange under Section 12(b) of the Exchange Act. (No such exemption is required for the trading of security-based swaps on SB SEFs.)

By comparison, the Proposed SEC Rules would not apply to transactions in uncleared security-based swaps. The SEC has acknowledged that transactions in such swaps occur on organized platforms that would likely register as SB SEFs, and noted that persons who engage in such transactions would have to rely on the general exemptions from the registration set forth in Section 4 of the Securities Act. The SEC apparently recognizes that this may be problematic, and has asked whether it should consider additional exemptions under the Securities Act and Exchange Act for uncleared security-based swaps that are traded on national securities exchanges or SB SEFs.

The comment period for the Proposed SEC Rules closes on July 25, 2011. Because those Rules will not become final before July 16, the SEC has stated that it may extend the effectiveness of temporary rules that it adopted in January 2011 for cleared credit default swaps until the Proposed SEC Rules are adopted.

Next Steps

Derivatives market participants should review the CFTC and SEC proposals and orders to confirm that their ordinary derivatives activities fall within the parameters of these exemptions. If they do not, they should consider asking the regulators for further guidance and exemptive relief. They also should continue to prepare for the ultimate Dodd-Frank effective dates by creating comprehensive compliance procedures for both cleared and uncleared derivatives transactions.

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