

Corporate & Financial Weekly Digest

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CFTC Approves Sixth Series of Dodd-Frank Rulemakings

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The Commodity Futures Trading Commission held a public meeting on December 1 to propose its sixth series of rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act. The CFTC has published notification of (and, in most cases, requested public comment on) the following five rule proposals.

- **Further Definitions of Swap Dealer, Major Swap Participant and Eligible Contract Participant:** Section 721 of the Dodd-Frank Act creates basic definitions for the new categories of regulated entities “swap dealer” (SD) and “major swap participant” (MSP), and Section 712(d)(1) provides that the Securities and Exchange Commission and the CFTC, in consultation with the Federal Reserve Board, must further define these terms, as well as the term “eligible contract participant” (ECP).

Swap Dealers. The proposed rules define a “swap dealer” similarly to the Dodd-Frank Act, as any person who: (a) holds himself out as a dealer in swaps, (b) makes a market in swaps, (c) regularly enters into swaps with counterparties in the ordinary course of business for its own account, or (d) engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps. The CFTC states that it will interpret this definition such that the term would be able to evolve in the future as operations of the SDs and market practices develop. The proposal provides further information about the CFTC’s current understanding of the distinguishing features of SDs, that they generally: (1) accommodate demand for and facilitate interest in entering into swaps from other parties; (2) enter into swaps on their own standard terms; and (3) are able to arrange customized terms for swaps upon request, or to create new types of swaps at their own initiative. The proposed rules also set forth a number of conditions that must be met for a person to qualify for the de minimis exemption from registration as an SD set forth in the Dodd-Frank Act. Finally, the proposal would limit the application of the exclusion for 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,” as set forth in the Dodd-Frank Act, to swaps connected to the financial terms of the loan itself.

The CFTC has also contemplated and requested public comment on how swaps between persons under common control should be treated for purposes of the definition of SD and the application of the definition to persons that aggregate swap positions of other parties.

Major Swap Participants. Under the Dodd-Frank Act, a person is an MSP if any of the following is true: (a) such person maintains a “substantial position” in any of the major swap categories, not including any positions held for “hedging or mitigating commercial risk” or positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan; (b) such person’s outstanding swaps create “substantial counterparty exposure” that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (c) such person is a “financial entity” that is “highly leveraged” in relation to the amount of capital it holds, is not subject to capital requirements promulgated by a federal banking agency, and maintains a “substantial position” in any of the major swap categories. The definition excludes SDs and certain financing affiliates.

Under the CFTC’s proposal, a person has a “substantial position” in a major swap category if either of the following is true: (1) such person’s daily average current uncollateralized exposure in the applicable major swap category exceeds \$1 billion (other than the rate swap category, for which the threshold is \$3 billion), or (2) the sum of such person’s daily average current uncollateralized exposure plus potential future exposure in the applicable major swap category exceeds \$2 billion (other than the rate swap category, for which the threshold is \$6 billion). A person’s daily average current uncollateralized exposure is measured by marking such person’s swap positions to market (with a deduction for the value of posted collateral with respect to the swap positions) and calculating exposure on a net basis, according to the terms of any applicable master netting agreement. A person’s potential future exposure is determined by multiplying the total notional principal amount of such person’s swap positions by specified risk factor percentages (ranging from 0.5% to 15.0%, based on the type of swap and the duration of the position), discounting the amount of positions subject to master netting agreements (by a factor ranging between zero and 60%, depending on the effects of the agreement), and further discounting the amount of the positions by 80% if the swaps are cleared or subject to daily mark-to-market margining.

Under the proposed rules, positions held for “hedging or mitigating commercial risk” include any swap position that: (1) qualifies as bona fide hedging under Commodity Exchange Act (CEA) rules; (2) qualifies for hedging treatment under Financial Accounting Standards Board Statement No. 133; or (3) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise (where the risks arise in the ordinary course of business due to certain specified causes). Positions would not qualify as held for “hedging or mitigating commercial risk” if such positions are held for a purpose that is in the nature of speculation, investing or trading.

Under the CFTC’s proposal, a person’s outstanding swaps create “substantial counterparty exposure” if (1) such person’s daily average current uncollateralized exposure exceeds \$5 billion, or (2) the sum of such person’s daily average current uncollateralized exposure

plus potential future exposure exceeds \$8 billion. Substantial counterparty exposure would be calculated using the same method for “substantial positions,” though the calculation would not be limited to major swap categories and no exclusions for hedging or positions in employee benefit plans are provided.

Finally, the proposed rules provide that the term “financial entity” is as defined in CEA Section 2(h)(7), as amended by the Dodd-Frank Act, and set forth two possible definitions of “highly leveraged,” on which the CFTC requests comment: either an 8:1 or a 15:1 ratio of total liabilities to equity, as determined in accordance with U.S. generally accepted accounting principles.

Eligible Contract Participants. Under 723(a)(2) of the Dodd-Frank Act, a person that does not qualify as an ECP may only enter into swaps on designated contract markets. The CFTC proposal would amend the definition of an ECP to (a) include SDs and MSPs, and (b) clarify that in order for a commodity pool to qualify as an ECP, the pool must comply with the requirements of clause (iv) of the current definition, which is specific to commodity pools.

As required under the Dodd-Frank Act, these definitions were drafted jointly by the CFTC and the Securities and Exchange Commission.

- **Designated Contract Markets Core Principles and Other Requirements:** Section 723 of the Dodd-Frank Act requires that all swaps that can be cleared must be executed on designated contract markets (DCMs) or swap execution facilities (SEFs), unless no DCM or SEF will make the swap available for trading. Section 735 of the Dodd-Frank Act amends certain provisions of the CEA applicable to DCMs, which amendments include revising the core principles applicable to DCMs and introducing five new core principles: Core Principle 13 (disciplinary procedures), Core Principle 20 (system safeguards), Core Principle 21 (financial resources), Core Principle 22 (diversity of boards of directors) and Core Principle 23 (SEC). In connection with these statutory provisions, the CFTC has proposed new and amended rules, guidance and acceptable practices to implement the new and amended core principles and incorporate the trading and execution of swaps on DCMs. The proposals regulate the duties of DCMs in the following general categories: financial information and resource requirements, compliance obligations, operational capabilities, surveillance obligations and trading and products requirements. The proposed rules, guidance and acceptable practices will take effect 60 days after publication of the final rules in the *Federal Register*.
- **Derivative Clearing Organization Definitions, Procedures and Core Principles:** The CFTC has proposed rules applicable to derivatives clearing organizations (DCOs) under the Dodd-Frank Act. The proposal would amend the definitions of “clearing member” and “clearing organization” and introduce definitions for “customer initial margin,” “initial margin,” “spread margin,” “variation margin,” “margin call,” “back test,” “compliance policies and procedures,” “key personnel,” “stress test” and “systematically important derivatives clearing organization.” The proposed rules would also implement a number of procedural changes applicable to DCOs by: (a) eliminating the 90-day

expedited DCO application review schedule and establishing a 180-day review schedule for all DCO applications; (b) clarifying the procedures a DCO must follow when requesting a transfer of its registration in connection with a corporate change (including specifying what information must be included in such a request and requiring certain representations regarding compliance with the CEA); and (c) establishing the process a DCO must follow to seek CFTC approval of its rules to permit portfolio margining of futures and securities in a futures account. Additionally, the CFTC's proposal requires each DCO to designate a chief compliance officer (CCO) and sets forth the duties of the CCO (e.g., the preparation and submission of an annual compliance report to the CFTC). Finally, the proposed rules would codify Section 725(c) of the Dodd-Frank Act by implementing the following DCO Core Principles: Core Principle A (compliance), Core Principle H (rule enforcement), Core Principle N (antitrust considerations) and Core Principle R (legal risk).

- **Reporting, Recordkeeping, Public Information and Information Sharing Requirements for DCOs:** Section 731 of the Dodd-Frank Act amends certain DCO Core Principles set forth in the CEA. The CFTC's proposed rules would codify these amendments to the following Core Principles: Core Principle J (reporting), Core Principle K (recordkeeping), Core Principle L (public information) and Core Principle M (information sharing). With respect to Core Principle J, the proposed rule includes two categories of reporting requirements: (a) periodic reports, required daily, quarterly and annually; and (b) event-specific reports, the requirement for which is triggered by the occurrence of a specific event, such as significant financial changes at the DCO or a clearing member's difficulties (e.g., a default). The proposal would implement and clarify Core Principles K and J. In particular, with respect to Core Principle K, the proposed rule would require DCOs to maintain all records created pursuant to CFTC regulations governing DCOs, and, with respect to Core Principle J, the proposed rules impose an obligation on each DCO to publicly disclose certain information that would permit market participants to evaluate the risks associated with employing such DCO's services (such as clearing fees, margin methodology, financial resources, daily trading information and the DCO's rules and procedures). Finally, the proposal would codify Core Principle M in substantially the same form.
- **Reporting, Recordkeeping and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants:** Section 731 of the Dodd-Frank Act also establishes recordkeeping and reporting requirements for SDs and MSPs. The Dodd-Frank Act authorizes the CFTC to craft the details of these requirements, but states that all books and records of SDs and MSPs must be available for CFTC inspection and imposes daily trading recordkeeping, reporting and audit trail requirements for all swap transactions entered into by SDs and MSPs.

The CFTC has proposed that SDs and MSPs be required to maintain (1) basic corporate records (including, e.g., meeting minutes); (2) certain financial records; (3) documentation of complaints against personnel; (4) marketing materials; (5) records of information required to be submitted to a swap data repository and reported on a real-time public basis; (6) full and complete transaction and position information for all swap activities, including

all documents on which trade information is originally recorded; and (7) records of daily trade information related to pre-execution, execution and post-execution data sufficient to preserve all information necessary to conduct a comprehensive and accurate trade reconstruction for each swap. Pre-execution trade information includes all oral and written communications that lead to the execution of a swap. Transaction records set forth in item (6) above and all pre-execution trade data must be maintained in such a way that such information can be identified and searched by transaction and by counterparty. The proposed rules would require SDs and MSPs to report swap data in accordance with real-time public reporting rules proposed in the fifth series of CFTC rulemakings under the Dodd-Frank Act (discussed above).

Unless otherwise noted, the comment periods for these proposals will expire 60 days from the dates of their respective publications in the *Federal Register*. Information regarding all of the CFTC proposals, including the text of the CFTC releases, fact sheets and Q&As, can be found [here](#).

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