REGULATORY REFORM TASK FORCE

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Dodd-Frank Act Rulemakings—End-User Update

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This Legal Alert provides an overview of the status of significant rulemaking developments since the enactment of the landmark Dodd-Frank Wall Street Reform and Consumer Protection Act (D-F Act) this past summer, with a focus on those rules that will have an impact on end-users of derivatives. This paper addresses some of the important issues facing end-users and notes where the proposed rules would affect the derivatives activities of financial entity end-users and commercial entity end-users differently. As used herein, financial entities consist of entities that are not themselves swap dealers but are engaged in activities such as banking, insurance, or investing (e.g., insurers, hedge funds, mutual funds, commodity exchange-traded funds, energy traders and other investment entities). Commercial entities include manufacturers, energy firms, utilities, consumer products companies and service providers.[1]

Significant rulemaking developments impacting end-users are addressed below along with questions raised by the proposals:

- Definitions of Swap Dealer and Major Swap Participant – Will you fall into these definitions?
- Definition of Swap – When will a "swap" be defined? This is key to the applicability of Title VII, including: (1) the determinations of who is a swap dealer or major swap participant; (2) what transactions must be cleared; (3) margin requirements; and (4) swap-related capital requirements.
- Mandatory Clearing Requirements – Who determines what must be cleared? How broad is the end-user exemption to the clearing requirements? What is a derivatives clearing organization's role in the clearing process? How will cleared swaps be traded?
- Margin Requirements – Who sets the requirements? How will initial margin for cleared and uncleared trades be protected? What is the status of the so-called "end-user exemption" to the margin requirements for uncleared trades?
- Swap Recordkeeping and Reporting Requirements – Who is responsible? What is required to be kept and reported?
- Treatment of Certain FX Transactions – Will all FX transactions be swaps?
- Permissibility of Agricultural Swaps – Will agricultural swaps be allowed?
- Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements – What are the time frames for written confirmations? How will portfolio reconciliation and compression impact your outstanding trades?
- External Business Conduct Rules – What will govern the end-user relationship with swap dealers and major swap participants? Are "non-reliance" provisions a thing of the past? What disclosure will be provided and when will it be provided?
- Position Limits – When will they be imposed?

The vast majority of the rulemakings under the D-F Act are in proposed form and some have been published while others are yet to be published. To the extent that proposals have not yet been published,

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[1] There are other types of end-users that will be impacted by the D-F Act, such as nonprofits, high net worth individuals, so-called "Special Entities" (which include state and local governments, municipalities, and employee benefit plans), and foreign entities. However, this update does not specifically address the particular concerns of these categories of end-users.

this overview is based on what was discussed at the meetings where the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) voted on the proposed rules and on the brief summaries released by these regulators. Certain additional key rulemaking proposals are anticipated in January, including those relating to: (1) the definition of "swaps" and "security-based swaps"; (2) the margin and capital requirements for uncleared swaps that will be imposed upon swap dealers (SDs) and major swap participants (MSPs); and (3) position limits. Attached as Appendix A is the current status of rules that have been proposed to date under Title VII of the D-F Act and the due dates for comments. **Please note that comments on certain of these proposed rules are due within the next 30 days.** A link to our status chart relating to all rulemakings under Title VII can be found here.

The regulatory process is ongoing and therefore the answers to the questions addressed herein will continue to emerge and possibly change as proposed rulemakings that have been adopted are published, new rulemakings are announced, comments on proposed rules are submitted, and final rules are promulgated. As a result, we will continue to provide future updates as to how the changes to the regulatory landscape are changing from an end-user perspective over the next year.

I. Potential to Be Treated as a Swap Dealer or Major Swap Participant

It is unlikely that most end-users will be deemed SDs or MSPs. That said, certain end-users could meet these definitions under the proposals as they currently stand, and end-users should verify whether or not they meet the standards of each category because capital, margin, examination, reporting, business and additional clearing requirements will apply to these types of entities.

A. Swap Dealers. With respect to the SD definition, the proposed rule would capture entities that seek to accommodate the trading interests of other parties (i.e., entities acting in the manner of a dealer in derivatives), even if this may represent only a relatively small portion of an entity's business activities. Under the proposed rules, the exceptions for offering swaps in connection with a loan origination and "de minimis" swap dealing appear to be narrowly construed. On the other hand, the concern of a number of investment entities (such as hedge funds) that they would be classified as SDs under the D-F Act merely because they regularly enter into trades for their own account appears to have diminished given the emphasis the proposed rule places on "acting as a swap dealer."

Entities, particularly those financial entities that are not "insured depository institutions" (e.g., government-sponsored enterprises and credit unions), that offer swaps to customers in connection with lending activities will need to evaluate carefully whether they fall within the SD definition. However, the good news for those who will be required to register as an SD is that the proposed rule provides for a "limited" registration that would allow these financial entities to only register with respect to their limited SD activities.

There also seems to be a relatively low risk that commercial end-users will be classified as SDs unless they are acting like swap dealers in terms of making markets and accommodating the trading demands of counterparties. However, the published proposed rule regarding SD treatment will require careful review and analysis to assess how it will apply in particular circumstances. For example, will centralized hedging on behalf of affiliated entities or customers possibly result in SD treatment?

B. Major Swap Participant. With respect to the MSP definition, the proposed rule clarifies the three prongs of activities that would cause an entity to be deemed an MSP.[2] If the rule is enacted in its current form, the CFTC has indicted that the proposed definition would "capture" only a small number of entities (estimated to be no more than a dozen or so). Significantly, with respect to the first-prong test relating to speculative trading, the CFTC/SEC have liberally construed that prong's exclusion for swaps entered into "for hedging or mitigating commercial risk." The exclusion will include swaps that do not qualify for hedge accounting under generally accepted accounting principles (GAAP) and swaps that hedge balance sheet risk rather than risks arising from a narrower view of commercial activities (e.g., the manufacture or sale of goods). (See also discussion below with respect to hedging or mitigating commercial risk as it relates to the end-user clearing exemption.)

All three prongs of the MSP definition seek to assess whether an entity's swap activities create a material risk to the financial system. This is accomplished essentially in two ways.

> ***1. Substantial Position*.** First, the first and third prongs of the MSP definition measure "substantial position" by looking only to an entity's non-margined activities that are "out-of-the-money." Thus, the second prong of the MSP definition, which seeks to address whether a party's swaps "create substantial counterparty exposure," is effectively incorporated in the definition of "substantial position" under the first and third prongs. Unsecured, "in-the-money" positions are ignored under all three prongs. And more importantly, "out-of-the-money" positions for which the entity has posted collateral to its counterparty are basically eliminated as well. This means that cleared swaps and swaps with fully collateralized exposures are essentially eliminated from the computations.

Significantly, because of the way in which substantial position is defined without giving any effect to the uncollateralized exposure that entities have to their counterparties, the proposed rule seems to assume that the failure of a commercial end-user due to derivatives losses arising from the insolvency of an SD or an MSP would never pose a threat to the financial system. The final rule could, however, take a different approach.

> ***2. High Dollar Thresholds*.** The second way in which the proposed rules strictly limit the number of entities that will be classified as MSPs is by establishing high-dollar thresholds for each prong of the definition.[3] For example, with respect to the "Rates Category" of swaps, which will apparently encompass all interest rate and currency swaps, the threshold for "current

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[2] The first prong of the MSP definition includes any non-swap dealer that maintains a substantial position in swaps for any of the major swap categories, excluding both positions held for hedging or mitigating commercial risk, and certain positions maintained by employee benefit plans (or contracts held by such plans). The second prong includes any non-swap dealer 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. The third prong includes any non-swap dealer that: (1) is a financial entity; (2) is highly leveraged relative to the amount of capital that it holds and that is not subject to capital requirements established by an appropriate Federal banking agency (as defined in the Commodity Exchange Act, as modified by the D-F Act); and (3) maintains a substantial position in outstanding swaps in any major swap category.

[3] Under the first and third prongs of the MSP definition: (1) the "substantial position" thresholds for rate swaps are $3 billion in current exposure and $6 billion in current exposure plus future exposure; and (2) the "substantial position" thresholds for credit swaps, equity swaps and other commodity swaps are $1 billion in current exposure and $2 billion in current exposure plus future exposure. Under the second prong of the MSP definition, the "substantial counterparty exposure" thresholds are $5 billion in current exposure across all swap categories and $8 billion in current exposure plus future exposure across all swap categories.

uncollateralized exposure" under the first prong is proposed to be $3 billion. For the other three categories of swaps (credit, equity, and the "catch-all" category for other commodities), the proposed threshold under the first prong is $1 billion. It is fairly clear that there are relatively few end-users that would have swaps with current uncollateralized exposures above these thresholds.

The MSP definition also contains a separate computation that would take into account both current uncollateralized exposure and the potential future exposure ("outward" exposure under the proposed rule). Although it is not completely clear how future exposure will be measured, it appears that the computation will be based on a relatively small percentage of the notional amounts of outstanding "out-of-the-money" positions for interest rate and foreign exchange (FX) transactions (though it could be up to 15% for commodity trades), and that number also will be discounted significantly if the positions are either cleared or subject to daily margining requirements. Under the first prong, the "substantial position" thresholds for the combined current and future exposure test are double what they are for the current exposure test (i.e., $6 billion for the "Rates Category" of swaps, and $2 billion for the remaining three swap categories). The quantitative measures for substantial counterparty exposure under the second prong are higher but aggregate all categories of swaps and include commercial hedging transactions. The third prong, which is applicable to certain financial entities (i.e., those that are "highly leveraged" and that are not regulated by federal bank regulators), has the same thresholds as the first prong but includes in the calculation commercial hedging transactions.

While it is anticipated that most end-users will fall below these thresholds, end-users should verify this conclusion by calculating their current and their anticipated future exposure levels. In addition, end-users should confirm whether they would be "financial entities" subject to the more rigorous third-prong thresholds for classification as an MSP. Unless otherwise clarified, there is a possibility that certain entities not otherwise thought to be financial entities, including, for example, centralized hedging entities whose sole function is to hedge commercial risks of affiliates, may fall into the definition of "financial entity" for purposes of the MSP definition.

A copy of the CFTC/SEC Joint Proposed Rule on the definitions of Swap Dealer and Major Swap Participant is available at 75 Fed. Reg. 80174. **Comments on the proposed rule are due on February 22, 2011**.

II. Definition of a Swap

One of the key "unknowns" at this point is how the regulators will define the term "swap." If it is broadly defined to include many financial instruments with embedded derivative features (e.g., certain insurance products and loans that are not exempted as identified banking products) and continues to include FX currency swaps and forwards, then the number of financial institutions that may be required to register as SDs could increase, and the scope of such institutions' activities that would be subject to the SD regulatory regime would expand as well.

A number of financial entities have filed comments with the CFTC/SEC expressing concern about the potential scope of the statutory definition of "swap."[4] If the broad statutory language is not interpreted in a

[4] *See,* e.g., the Comment Letter of the Federal Home Loan Banks, dated September 20, 2010, which is available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26242&SearchText=Federal%20Home%20Loan%20Banks and

manner consistent with the clear legislative intent to regulate the over-the-counter (OTC) derivatives market (i.e., the swaps and options market that has developed under International Swaps and Derivatives Association, Inc. (ISDA) documentation over the past 20 years), many everyday commercial transactions that no one has considered "swaps" could become subject to extensive CFTC/SEC regulation or, indeed, become illegal. (See also discussions below regarding certain FX transactions and agricultural swaps.)

The CFTC and SEC expect to propose rules regarding the "swap" definition sometime in January.

III. Mandatory Clearing

A. Mandatory Clearing. Section 723(a) of the D-F Act amends the Commodity Exchange Act (CEA) to provide that "it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization (DCO) that is registered under the CEA or a DCO that is exempt from registration under the CEA if the swap is required to be cleared." The regulatory actions to date have not addressed this issue in a way that clearly puts market participants on notice as to what swaps will be eligible for clearing, and this makes it difficult for end-users to fully assess the impact of being required, either by the D-F Act or by their counterparties, to enter into cleared transactions (e.g., margin requirements associated with cleared swaps). The CFTC issued a proposed rule earlier this year that set forth the process for review of swaps for mandatory clearing. This proposed rule essentially outlines the steps that a DCO must take in order to be eligible to clear. The determinations that the CFTC ultimately makes pursuant to a final version of this proposed rule will impact what swaps are subject to the D-F Act's mandatory clearing requirement because, as noted above, subject to certain exceptions in the D-F Act and the CFTC's implementing regulations, to the extent a DCO accepts a particular swap, group, category, type or class of swaps for clearing, it will be unlawful to enter into such transactions on an uncleared basis.

The CFTC's proposed rule contains a presumption that, subject to CFTC review, a DCO will be eligible to clear any swap that is within a group, category, type or class of swap that the DCO currently clears. Certain credit default swaps and energy swaps are being cleared currently, and it is assumed that those will certainly be subject to the new mandatory clearing requirements. Also, currently a high percentage of interest rate swaps between dealer counterparties are being cleared, and there seems to be an expectation that a significant percentage of "customer" interest rate transactions will also be eligible for clearing in the near future. Several clearinghouses have announced their intentions to offer clearing for certain interest rate swaps, and some limited clearing of end-user interest rate swaps is already occurring. There is an expectation that a high percentage of interest rate swaps will be eligible for clearing in the relatively near future, but at this point it is impossible to assess how quickly this will occur with respect to different types of interest rate swaps. Another point to note regarding this proposed rule is that, to the extent a swap is not accepted by any DCO but the CFTC nonetheless determines that it would otherwise be subject to the D-F Act's mandatory clearing requirements, the CFTC's proposed rule would give the CFTC the right to impose margin, capital and other requirements on parties to such swaps.

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the Comment Letter from the Committee of Annuity Insurers, dated December 3, 2010, which is available at: http://www.sec.gov/comments/s7-16-10/s71610-130.pdf.

Finally, this proposed rule contains a provision allowing a counterparty to a swap to request a stay of the D-F Act's clearing requirements for that particular swap. If the CFTC grants such a stay, it will then have 90 days to determine whether the D-F Act's clearing requirement will apply to the particular swap.[5]

A copy of the CFTC Proposed Rule on the process for review of swaps for mandatory clearing is available at 75 Fed. Reg. 67277. **Comments on the proposed rule were due on January 3, 2011. Comments submitted to the CFTC with respect to this proposed rule can be found at** http://comments.cftc.gov/PublicComments/CommentList.aspx?id=890.

B. End-user exemption from mandatory clearing. The D-F Act and a proposed rule issued by the CFTC do contain a so-called "end-user exemption" from the D-F Act's clearing requirements. End-users that are *not financial entities* and that enter into swap transactions to hedge or mitigate their commercial risks may, but will not be required to, clear their swap transactions. The proposed rule containing this end-user exemption also asks questions about whether this exemption should extend to certain small financial institutions including credit unions and Farm Credit System institutions.

Consistent with the broad category of swaps excluded from the calculation of exposure for MSP status, it appears that the proposed rules will broadly construe which swaps are deemed to be employed to "hedge or mitigate commercial risk." Consistent with the MSP definition, for purposes of this end-user exemption, these "hedging" swaps would include, but not be limited to, swaps that qualify for bona fide hedging under the CEA rules or for hedging treatment under GAAP. Also qualifying for this purpose will be swaps that seek a reduction of risks in the conduct and management of a commercial enterprise, whether the risks arise from:

a) a potential change in the value of
   i) assets that a person owns, produces, or sells,
   ii) liabilities that a person incurs, or
   iii) services that a person provides or purchases;
b) potential changes in value of any of the foregoing arising from foreign exchange rate movements; or
c) fluctuations in interest, currency or foreign exchange rate exposures arising from a person's assets or liabilities.

This would seem to exclude only swaps entered into for speculative or trading purposes. As a result, commercial end-users should be largely exempt from the mandatory clearing requirements of the D-F Act.

End-users will have to notify the CFTC about any uncleared swap transactions that they enter into in accordance with the "end-user exemption." The CFTC is proposing a "check-the-box" form that end-users would fill out to comply with this notice requirement. (See below for a discussion of whether end-users who qualify for the "end-user exemption" from mandatory clearing will also be exempt from mandatory margin requirements for uncleared trades.)

[5] See the comment letter of the Federal Home Loan Banks, dated January 3, 2010, which is available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26869&SearchText=

A copy of the CFTC Proposed Rule on the end-user exception to mandatory clearing is available at 75 Fed. Reg. 80747. **Comments on the proposed rule are due on February 22, 2011.**

C. Derivatives Clearing Organizations. The CFTC has issued several proposed rules for DCOs. One of these proposed rules, which has not yet been published in the Federal Register, relates to risk management for DCOs and addresses the DCO application process and implements six core principles for DCOs. While this proposed rule is not directly applicable to end-users, the core principles implemented by the proposed rule will likely have an indirect impact on end-users' swap activities, including the margin they are required to post for cleared swaps. These core principles address participant and product eligibility, risk management, settlement procedures, treatment of funds, default rules and procedures and system safeguards.

With respect to participant and product eligibility, the proposed rule requires DCOs to establish generally unrestrictive eligibility criteria. Such eligibility criteria may account for financial resources (including minimum capital) and operational criteria but may not exclude potential members of the DCO based on the size of their swap portfolio, their designation (or lack of designation) as a swap dealer or major swap participant, or the volume of their swap trading. To the extent that this proposed rule requires DCOs to accept more clearing members, it should increase an end-user's options in choosing clearing members for their cleared swaps. However, expanding the number of clearing members poses risk management issues for both the clearinghouses and end-users. As will be discussed below, the insolvency of a clearing member poses economic risk to end-users who clear swaps through such clearing member.

This proposed rule requires DCOs to establish margin methodologies within certain parameters but leaves it up to the DCOs to actually calculate and collect margin. Such margin must be set at a minimum 99% confidence level based on historic performance. Additionally, this proposed rule requires DCOs to calculate margin for their clearing members based on trades at the individual customer level and prohibits DCOs from netting margin at the clearing member level. This aspect of the proposed rule is actually a significant departure from the futures model in which DCOs can net collateral that they would owe to one customer of a clearing member against collateral that another customer of the same clearing member would owe to the DCO. In another significant departure from the futures model, and consistent with the foregoing margin requirements, this proposed rule also requires DCOs to report end-of-day positions at the customer level as opposed to the clearing member level. Each of these departures from the futures model puts the CFTC in a position to be able to propose rules requiring DCOs to segregate collateral at the customer level if it chooses to do so. (See the December 10, 2010, Advanced Notice of Proposed Rulemaking relating to the Protection of Cleared Swap Customers Before and After Commodity Broker Bankruptcies. 75 Fed. Reg. 75162.)

Copies of the CFTC's releases for its Proposed Rule on Risk Management for DCOs are available: Fact Sheet and Q&A. No due date has been set for comments since the proposed rules have not been published in the Federal Register. It is anticipated that comments will be due 60 days after such publication.

D. Venues for Cleared Swaps. Under the Dodd-Frank Act, all swaps that are required to be cleared must be executed on a swap execution facility (SEF) or a Derivatives Contract Market (DCM), unless no SEF or DCM makes the swap available for trading. Block trades and trades involving end-users who take advantage of the end-user exemption from clearing may also, but do not have to, be transacted on a SEF. Once swaps are entered into on a SEF or DCM, they will be sent to a DCO for clearing (to the extent they are required to be cleared or the parties elect to submit them for clearing). The CFTC has approved several proposed rules addressing “core principles” and other requirements for DCMs and SEFs. DCMs generally consist of the existing exchanges (e.g., the Chicago Mercantile Exchange (CME) and International Derivatives Clearinghouse LLC (IDCH)). SEFs, however, are a new concept created by the D-F Act.

The D-F Act charges the CFTC with promulgating regulations to clarify what would constitute a SEF, how SEFs would function and what rules would apply to SEFs. Based on statements of the CFTC staff and the Commissioners, this proposed rule has been particularly challenging because SEFs are a new concept and, as such, no SEFs exist in today’s market. The CFTC has approved a Proposed Rule on core principles and other requirements for SEFs, but this rule has not yet been published in the Federal Register.

SEFs are meant to bring more transparency to the swaps market. According to this proposed rule, a SEF is a trading system or platform in which market participants can both post and respond to requests for quotes (RFQs), indicative quotes and firm quotes (i.e., order books). All RFQs on a SEF must be transmitted to at least five market participants in the SEF and must be visible to all of the SEF’s participants. Additionally, there will be a 15-second “pause” after a quote or an RFQ is submitted to a SEF. We understand that this “pause” is meant to give other market participants an opportunity to view and act on the quote or RFQ if they choose to do so. To the extent that a trade is required to be executed on a SEF, the foregoing requirements essentially prohibit market participants from entering into a trade that they have agreed to bilaterally—a huge departure from the existing OTC system and more in line with the existing futures system.

Many aspects of this proposed rule and the SEF concept in general are still unclear. For instance, we do not know whether each SEF will have relationships with numerous DCOs or whether market participants who utilize one SEF will be forced to clear the trades they enter into on that SEF through a certain DCO associated with the SEF. If each SEF is associated with only one DCO, then to the extent a market participant has to utilize a number of SEFs because they enter into a number of different types of swaps, the market participant may have to associate with clearing members for the different DCOs associated with each SEF it trades on. Additionally, if trading with SEFs requires market participants to use multiple DCOs, then market participants will lose the benefits of collateral netting that they could otherwise achieve by clearing all of their trades through one DCO and a single clearing member. At this time we also do not know what would happen to a trade that is executed on a SEF and then not accepted for clearing. Hopefully the answers to these and many other questions will be forthcoming when this proposed rule is published in the Federal Register. The comments that the CFTC receives for this proposed rule will be of particular importance as the agency seeks to promulgate a final rule for a trading system that does not currently exist in the market.

Copies of the CFTC’s releases for its Proposed Rule on SEFs are available: Fact Sheet and Q&A.

IV. Capital and Margin Requirements

A. Capital and Margin Requirements for Cleared Trades. According to proposed CFTC rules, the initial margin for cleared swaps will be set by the clearinghouses, subject to some minimum regulatory requirements. (See the Proposed Rule on DCO Risk Management discussed above.) Capital requirements for swap dealers and major swap participants who enter into cleared trades will be set by the CFTC, the SEC or the prudential regulators, as applicable.

Whether posted margin will be at risk in the event of a default by other customers of the clearing member is completely open at this point. Many OTC end-users were surprised to learn that if the CFTC "futures model" is adopted for cleared swaps, their margin indeed could be at risk in the event their clearing member defaulted to a clearinghouse as the result of defaults by other customers of the clearing member. The CFTC and the SEC held a roundtable on this issue and subsequently issued an Advanced Notice of (so-called "fellow customer risk") Proposed Rulemaking (ANPR) requesting input on three alternatives to the existing futures model.

A copy of the CFTC ANPR on Collateral Segregation for Cleared Swaps is available at 75 Fed. Reg. 75162. **Responses to the ANPR are due by January 18, 2011.**

With respect to what additional margin may be required by clearing members over and above the amounts required by the clearinghouse, there has been no regulatory guidance. Presumably, this will be the subject of discussions and contractual agreement between customers and their clearing members. The timing of margin payments will be governed by clearinghouse rules and the agreement between the customer and its clearing member. Currently there is an effort, under the auspices of the Futures Industry Association (FIA), to develop an "Addendum" that can overlay a customer's futures agreement with its clearing member. The Addendum will address certain issues associated with clearing swaps rather than futures contracts. These include provisions relating to: (1) clearing member and customer representations and warranties; (2) the transfer of positions to another clearing member at the request of a customer; (3) the authority of a clearing member upon a customer's default; and (4) tax matters. The FIA also intends to develop a standardized "Cleared Derivatives Give-Up Agreement" that will set out contractual terms governing the submission of swaps for clearing.

It is intended that the Addendum and the Cleared Derivatives Give-Up Agreement will be the starting point for putting the necessary documentation in place between customers and their clearing members for clearing swaps. Please note that the Addendum will supplement the clearing member's form of customer futures agreement. These agreements, like brokerage account agreements, historically have not been negotiated by customers and, unlike the ISDA Master Agreement, vary from clearing member to clearing member. In addition, these agreements incorporate by reference the requirements of the various exchanges and clearinghouses through which cleared swaps and futures are traded and cleared. It is anticipated that end-users with bargaining power in negotiating with banks and other dealer counterparties will seek to negotiate changes to their clearing members' forms of customer futures agreement.

B. Capital and Margin Requirements for Uncleared Trades. As of this date, the SD and MSP margin and capital requirements for uncleared swaps have not been addressed by either the CFTC or the SEC. Proposed rules on these issues are expected to be announced sometime in January. Based on comments by certain Commissioners and staff at a CFTC/SEC roundtable held in December, there seems to be some recognition that margin requirements should not be imposed retroactively on swaps entered into prior to the enactment of the D-F Act. How swaps entered into between the date of enactment and the effective date of the new margin rules will be treated remains a more open question.

C. End-User Exemption From Mandatory Margin Requirements for Uncleared Trades. The statutory language in the D-F Act requires the CFTC and the SEC (and the other prudential regulators) to establish "both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization." Generally speaking, financial institutions entering into transactions with SDs or MSPs are expected to be subject to mandatory margin requirements. However, it appears that the regulators are considering exempting from margin requirements transactions of commercial end-users that are exempt from mandatory clearing. This move would be consistent with the views expressed in the so-called Dodd-Lincoln letter.[6]

The implications of a commercial end-user exemption from margin with respect to uncleared trades, if proposed, will not be fully understood until it is determined how SDs and MSPs will react to such an exemption. Concerns are being voiced about the capital and liquidity implications of any such exemption for SDs and MSPs. How will they respond if their capital requirements are increased as a result of not obtaining margin from commercial end-users, or their liquidity demands are heightened because they are required to post margin on hedging transactions when they are not receiving margin from end-users? Will swap transaction costs and spreads increase? Will SDs and MSPs feel constrained to require margin from commercial end-users as a business matter, even if they are not required to do so by regulators? This matter will likely remain a key concern of commercial end-users regardless of how the regulatory rules are written.

D. End-User Use of Non-Cash Margin. Whether end-users may post non-cash margin is an issue for both cleared trades and uncleared trades. The D-F Act contemplates that non-cash collateral will be permitted for uncleared swaps to the extent that the regulators determine such collateral arrangements are consistent with preserving the financial integrity of the swaps trading market and the stability of the U.S. financial system. With respect to cleared swaps, the margin rules will be set by the clearinghouses and clearing members within the regulatory framework established by the CFTC and SEC. The proposed rule discussed above regarding DCO risk management leaves the decision about whether market participants may post non-cash collateral to the individual DCOs.

E. Segregation of Initial Margin for Uncleared Trades. Under the D-F Act, parties that post initial margin to SDs or MSPs will have a statutory right to insist that such margin be held in a segregated account with an independent custodian. This new right is the result of losses incurred by various counterparties in connection with the Lehman bankruptcy and the difficulties end-users have had in negotiating with SDs for satisfactory arrangements to protect initial margin (or "Independent Amounts" in ISDA terminology) from loss in the event that the SD becomes insolvent. Up to now, initial margin has generally been required from only a limited number of market participants, mainly hedge funds, that are perceived to pose significant credit risk to the dealer counterparties. However, as discussed above, it appears that, going forward, initial margin likely will be required of most financial institutions participating in the OTC derivatives markets. Thus, non-dealer banks, investment entities, and insurance companies may find themselves posting significant amounts of initial margin. It will therefore be important for financial institutions to carefully review and comment on the proposed rules that will implement this new statutory right.

The CFTC's Proposed Rule on Collateral Segregation for Uncleared Trades raises several issues for end-users:

1. ***Disclosure of Additional Costs.*** Should SDs and MSPs be required to disclose the additional costs to be incurred by the end-user counterparty if it elects to exercise its statutory right to insist on segregation of initial margin? Such costs could include both the custodial costs of the independent

[6] Letter dated June 30, 2010, from Senators Christopher Dodd and Blanche Lincoln to the Chairman of the House Financial Services Committee and the Chairman of the Senate Committee on Agriculture.

custodian and any additional SD or MSP charges reflecting that the SD or MSP will not be able to rehypothecate initial margin held by a custodian. It is also possible that the additional cost will be embedded in the swap pricing (as opposed to a separately stated charge).

2. Selection of the "Independent Third-Party Custodian." The proposed regulation requires the custodian to be "independent of both the swap dealer or major swap participant and the counterparty," but is otherwise silent about who is entitled to designate or select the custodian. Moreover, the proposed regulation fails to provide clear guidance as to what constitutes an "independent" custodian. End-users must consider whether this new statutory right can be effectively vitiated by the SD or MSP counterparty selecting a custodian who charges inordinately high fees, imposes commercially unreasonable custodial terms, or is not financially sound.

3. Agreement Governing Segregated Collateral. The proposed regulation seems to require that segregated margin be held pursuant to a tri-party agreement signed by both parties to the swap and by the custodian. Except for a particular requirement pertaining to the "[t]urnover of control of such margin" (discussed below), the proposed regulations are silent on the terms of such an agreement. The terms of the tri-party agreement will likely be critical to the decision of an end-user counterparty to exercise or forego its right to have margin segregated. This raises the question of whether the final regulations should require that the agreement proposed by the SD or MSP be commercially reasonable. This would preclude an SD or MSP from offering segregation on terms that are designed to discourage end-users from exercising their statutory rights. Currently, a working group organized under the auspices of ISDA is attempting to reach agreement on terms that would be generally acceptable to both pledgors and secured parties who elect to have initial margin held by a third-party custodian under a tri-party agreement. Thus, by the time these regulations become effective, there should be a standard for determining whether the terms of the agreement offered by an SD or an MSP meet a commercially reasonable standard.

4. Transfer of Initial Margin. The circumstances and conditions for the transfer of margin from the custodian to either the end-user counterparty or the SD/MSP go to the heart of the tri-party agreement between the parties. It seems critical that the terms specified in the agreement of the parties be "commercially reasonable" or, to state it differently, generally acceptable to both the party posting the margin and the party with a security interest in the margin. Provisions that skew the rights in favor of one party or the other could effectively vitiate this important statutory right. From the perspective of the end-user counterparty, it is most important that: (1) the margin be protected against inappropriate transfer to the SD or MSP when the solvency of the SD or MPS party is in doubt; and (2) the margin be promptly returned to the end-user counterparty upon the actual insolvency of the SD or MSP.

5. Investment of Initial Margin. The proposed regulations provide that segregated initial margin "may only be invested consistent with § 1.25 of this Chapter." The § 1.25 regulations govern certain margin held by futures commission merchants (FCMs) in connection with margin provided to secure *regulated futures* transactions. This requirement seems unnecessarily restrictive and inconsistent with both present market practice and the language of the D-F Act. There is nothing in the D-F Act that says that margin held by a third-party custodian to secure uncleared swaps should be subject to the same or even similar requirements applicable to margin posted for cleared trades. The rationale articulated for the more restrictive investment provisions of § 1.25 is that *only* the FCM, and *not the customer*, is making the investment decisions with respect to the customer's funds posted as margin for cleared swaps. This is clearly not the case with respect to the present swaps market, where it is market practice for the parties to mutually agree upon how margined funds will be invested and how gains/losses will be allocated.

A copy of the CFTC Proposed Rule on Collateral Segregation for Uncleared Trades is available at 75 Fed. Reg. 75432. **Comments on the proposed rule are due on February 1, 2011.**

V. Swap Recordkeeping and Reporting Requirements

The CFTC has proposed two rules with respect to reporting swap transaction data. Both of these rules apply to all swap market participants, regardless of whether they are SDs or MSPs. As discussed below, however, end-users that are not SDs or MSPs will generally not be subject to reporting requirements, but will still be subject to recordkeeping requirements.[7] To the extent that neither counterparty to a swap transaction is an SD or an MSP, we assume that the financial institution counterparty will be designated as the "reporting party" for general reporting purposes and for purposes of the D-F Act's real-time reporting requirements. It is unlikely that commercial end-users will have any reporting requirements unless they are entering into swap transactions with other commercial end-users.

The proposed recordkeeping rules are intended to ensure very prompt public reporting of pricing for swap transactions. CFTC Chairman Gensler is a strong advocate of requiring greater pricing transparency to eliminate what he refers to as Wall Street's "information advantage." In commenting on the proposed public reporting requirements, end-users will need to weigh the benefits of greater price transparency against the possible negative impact such reporting may have on liquidity and pricing. SDs contend that prompt public reporting for highly structured transactions may result in reduced liquidity and higher spreads because SDs will not have sufficient time to enter into hedging transactions in a cost-effective manner. It may be very difficult for end-users, and ultimately the CFTC, to assess the validity of the arguments made on both sides of this issue in the absence of real, empirical evidence.

A. Swap Data Recordkeeping and Reporting Requirements. The first proposed rule, which addresses "Swap Data Recordkeeping and Reporting Requirements," sets forth what information must be maintained by counterparties to a swap transaction and what information about a swap transaction must be reported to a Swap Data Repository (SDR). This proposed rule is meant to provide the CFTC and other regulators with information they need to regulate the currently unregulated swap market. This data will not be made publicly available. This proposed rule differentiates between: (1) swaps entered into on a SEF or a DCM and cleared through a DCO; (2) swaps entered into on a SEF or a DCM but not cleared through a DCO; (3) swaps that are not entered into on a SEF or a DCM but that are cleared through a DCO; and (4) swaps that are not entered into on a SEF or DCM and are not cleared through a DCO.

1. Reporting. Which of the above categories a swap falls into determines the entity required to report the transaction data for the swap. Generally, if a swap is entered into on a SEF or a DCM, then the SEF or DCM is responsible for reporting the "primary economic terms" of the

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[7] In addition, the CFTC has issued two interim final rules that deal with reporting requirements for: (1) swaps that were entered into before the enactment of the D-F Act (75 Fed. Reg. 63080); and (2) swaps that are entered into between the enactment date and the effective date of the CFTC's final reporting rules (this interim final rule, adopted on December 16, 2010, has not yet been published in the Federal Register.) Each of these interim final rules direct all market participants (including end-users) to retain all data for such swap transactions to the extent that they currently maintain the data in the ordinary course of their business. The interim final rules do not require market participants to create any new data or records at this time.

transaction to an SDR. Additionally, if a swap is cleared through a DCO then the DCO is responsible for reporting the information about the confirmation of the swap and is also responsible for reporting certain life-cycle data throughout the term of the swap transaction. Otherwise, the "reporting party" is obligated to report the requisite information about a swap transaction. If an SD or an MSP enters into a transaction with an end-user, then the SD/MSP will always be the reporting party. A market participant that is neither an SD nor an MSP will not be required to report any information under this proposed rule unless it enters into swaps with counterparties that are also neither SDs nor MSPs. In such instances, the parties will be required to specify which counterparty will be the "reporting party" in the confirmation of the swap transaction. We assume that to the extent a financial institution that is not an SD or MSP enters into a swap with a non-financial institution that is also not an SD or MSP, the financial institution counterparty will likely be designated as the "reporting party." At this point, the determination of the "reporting party" is entirely up to the counterparties to the swap transaction, but the proposed rule does ask a question about whether the CFTC should be more prescriptive on this issue.

The proposed reporting rule accounts for the fact that non-SDs/non-MSPs may not be able to provide certain information about swap transactions as quickly as SEFs/DCMs/DCOs or SDs/MSPs can provide such information. The proposed rule asks for comments on the appropriate deadline for reporting swap transaction information when the reporting party is not an SD or an MSP. The proposed rule does, however, require all reporting parties (including those that are not SDs or MSPs) to report the primary economic terms of a swap transaction as soon as technologically practicable.

2. Recordkeeping. This proposed rule also requires swap market participants who are not SDs or MSPs to maintain "full, complete, and systemic records, together with all pertinent data and memoranda, with respect to each swap in which they are a counterparty, including all required swap creation data and all required swap continuation data that they are required to report [pursuant to the proposed rule], and including all records demonstrating that they are entitled, with respect to any swap, to the end user exception [from the D-F Act's clearing requirements]." This information generally must be maintained throughout the life of the swap and for at least five years thereafter. For all counterparties that are not SDs or MSPs, this information must be retrievable within three business days.

A copy of the CFTC Proposed Rule on the swap recordkeeping and reporting requirements is available at 75 Fed. Reg. 76574. **Comments on the proposed rule are due on February 7, 2011.**

B. Real-Time Reporting. The second proposed rule, which addresses "Real-Time Public Reporting of Swap Transaction Data," sets forth the swap transaction information that must be made publicly available within certain prescribed time periods. The information reported pursuant to this proposed rule will not include the identities of the counterparties to a swap transaction.

The proposed rule on real-time reporting also distinguishes between swaps entered into on a SEF or DCM and swaps that are not executed on such a trading system or platform. Counterparties to swaps that are entered into on a SEF or DCM will not have any additional reporting requirements under this proposed rule. The SEF or DCM will be required to report price and volume data about the swap transaction to an SDR "as soon as technologically practicable." The proposed rule describes and provides examples of what such price and volume data must include. Unless the swap transaction constitutes a block trade or large notional swap, the SDR must then publicly disseminate the price and volume data "as soon as technologically practicable." For block trades or large notional swaps, the SDR must wait for a prescribed period of time before publicly disseminating the data.

For swaps not entered into on a SEF or a DCM, one of the counterparties will be required to report the price and volume data for the transaction to an SDR "as soon as technologically practicable." Under the proposed rule, the counterparty with this reporting obligation will always be an SD or an MSP unless both parties to the swap transaction are neither SDs nor MSPs. In such instances, the parties to the swap must designate who will report this information. As discussed earlier, we assume that if one counterparty is a financial institution and the other counterparty is not, the financial institution counterparty will likely be designated as the "reporting party."

A copy of the CFTC Proposed Rule on the real-time reporting requirements is available at 75 Fed. Reg. 76140. **Comments on the proposed rule are due on February 7, 2011.**

VI. Treatment of Certain FX Transactions

At this time, it is unclear how foreign exchange swaps will be treated under the D-F Act. While foreign currency swaps and forwards are included in the Act's definition of swaps, amended § 1a(47)(E) of the CEA empowers the Secretary of the Treasury (Treasury Secretary) to categorically exempt foreign exchange swaps and forwards from being regulated as "swaps" under the CEA, as amended by the D-F Act. Even if the Treasury Secretary determines that foreign exchange swaps and forwards should not be regulated, these transactions will be subject to swap reporting requirements, and any SDs or MSPs engaging in these transactions must conform to swap business conduct standards.

On October 28, 2010, the Department of the Treasury (Treasury Department) published a notice in the Federal Register seeking public input on whether foreign exchange swaps and/or forwards should be exempt from the D-F Act's regulatory framework for swaps. The Notice contained a series of questions and also asked members of the public to comment on factors the Treasury Secretary should take into account in determining whether an exemption is necessary for foreign exchange swaps and forwards. The CEA defines a foreign exchange swap as either: (1) a transaction that involves an exchange of two different currencies on a specific date at a fixed rate; or (2) the reverse exchange of the two currencies in (1) at a later date at a fixed rate. A foreign exchange forward is a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate. Thus, both foreign exchange swaps and forwards fall under the definition of a "swap" under the D-F Act. Accordingly, subject to the possible Treasury Department exemption, foreign exchange swaps and forwards will be subject to the D-F Act's regulatory regime once it becomes effective.

If foreign exchange swaps and/or forwards are exempted by the Treasury Secretary, they would not be subjected to the D-F Act's clearing and margin requirements, among other things. In deciding whether to issue such an exemption the Treasury Secretary is charged with considering several factors, including: (1) whether the required trading and clearing of foreign exchange swaps and forwards would create systemic risk, lower transparency or threaten the financial stability of the United States; (2) whether foreign exchange swaps and forwards are already subject to a regulatory scheme that is materially comparable to that established by the CEA for other classes of swaps; (3) the extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements; (4) the extent of adequate payment and settlement systems; and (5) the use of a potential exemption of foreign exchange swaps and/or forwards to evade otherwise applicable regulatory requirements. Although financial institutions are generally supportive of the exemption, it is not clear at this time what action the Treasury Secretary will take.

The Treasury Department is expected to make its determination during the spring of 2011.

Commercial end-users have expressed the view that an exemption by Treasury Department is warranted because FX transactions tend to be of a short-term duration (typically one day to one week) and are generally physically settled by delivery of the underlying currency in a well-developed market where the counterparties are typically heavily regulated bank intermediaries. Moreover, unlike transactions cleared through a central counterparty where credit risk is concentrated in a single entity, FX swaps and forwards are entered into by multinational companies with a diverse group of creditworthy bank counterparties regulated by central banks, such as the Federal Reserve Banks in the United States.

The short-term nature of the vast majority of FX transactions is unlikely to change for commercial end-users, since the nature of cash management and predictability of cash flows will generally force companies to focus on the short-term. In addition, credit exposure to each counterparty tends to offset itself over time and across various counterparties. The sum of positive and negative market values of a party's FX exposure usually approaches zero in a typical multinational company's derivative portfolio, which is constantly rolled over at new market rates.

Commercial end-users contend that treating FX transactions as swaps under the D-F Act will result in unnecessary imposition of additional regulatory requirements, including capital and margin requirements that will increase the cost and complexity of doing these transactions. For example, the collateral that businesses would have to post as margin to comply with the new requirements will undoubtedly increase funding costs and restrain liquidity (particularly for non-financial institutions), and introduce serious cash-flow management issues. Further, there will be increased administrative burdens on parties to manage and monitor these transactions and their margin requirements. To the extent these additional burdens discourage the use of these instruments for hedging, market risks will increase rather than decrease.

A copy of the Treasury Department Notice on FX Transactions is available at 75 Fed. Reg. 66426. **Comments were due on November 29, 2010. Copies of comments submitted to the Treasury Department in response to the Notice can be found at** http://www.regulations.gov/#!docketDetail;rpp=10;so=DESC;sb=postedDate;po=0;D=TREAS-DO-2010-0006.

VII. Permissibility of Agricultural Swaps

Notwithstanding the D-F Act's general provisions regarding the definition and regulation of "swaps," which would include agricultural swaps, § 723(c)(3) of Dodd-Frank explicitly prohibits swaps in agricultural commodities unless they are entered into pursuant to a CFTC rule, regulation, or order granted under § 4(c) of the Commodity Exchange Act.[8] As a result, it is unclear whether agricultural commodity swaps

[8] Agricultural commodity swaps are currently governed by Part 35 of the CFTC's rules, and options on agricultural commodities are currently permissible under Part 32 of the CFTC's rules. While Dodd-Frank provides that those agricultural commodity swaps (not options) meeting the Part 35 rules that were in place before Dodd-Frank was enacted will continue to be permitted pursuant to a "grandfather clause," the post-Dodd-Frank regulatory reforms might well revise such current regulations substantially.

will be subject to the comprehensive regulatory framework that Dodd-Frank establishes for swaps or to a different regulatory framework adopted by the CFTC. Importantly, pursuant to its authority under § 723(c)(3) of Dodd-Frank, the CFTC may impose a variation of this regulatory framework on agricultural swaps, or it may adopt completely distinct requirements for them.

Earlier this year the CFTC issued an ANPR requesting public comments addressing (among other things): (1) the current agricultural swaps business; (2) the potential effect of requiring agricultural swaps to be cleared under the Dodd-Frank clearing regime; (3) pros and cons of permitting agricultural swaps to be cleared on DCMs or SEFs; and (4) the pros and cons of permitting agricultural swaps to be traded outside of DCMs and SEFs to a different extent than other types of swaps.

A copy of the CFTC ANPR on Agricultural Swaps is available at 75 Fed. Reg. 59666. **Comments on the ANPR were due on October 28, 2010. Copies of comments submitted to the CFTC in response to the ANPR can be found at** http://comments.cftc.gov/PublicComments/CommentList.aspx?id=765.

VIII. Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants

A. Confirmation Requirements. The first part of this proposed rule requires swap dealers and major swap participants to provide their counterparties with acknowledgments and/or confirmation for all trades within certain periods of time. If the parties to a swap transaction are both swap dealers or major swap participants, then they must execute a confirmation on the same day that they enter into the swap. If a swap dealer or major swap participant enters into a swap with a counterparty that is not a swap dealer or major swap participant, the swap dealer/major swap participant must provide its counterparty with an acknowledgment of the transaction on the same day the swap is entered into. In such cases, if the counterparty is a financial entity, then the parties must also execute a confirmation on the same day the swap is entered into. If the counterparty is not a financial entity, then the parties must execute a confirmation on the following business day. With respect to complex/highly structured OTC trades in particular, these time frames will pose serious challenges for market participants.

B. Portfolio Reconciliation. The second part of this proposed rule requires swap dealers and major swap participants to engage in portfolio reconciliation with respect to all of their uncleared swap transactions. Swap dealers and major swap participants must reconcile their portfolios with other swap dealers and major swap participants on a daily (for portfolios containing 300 or more swaps), weekly (for portfolios containing more than 50 but fewer than 300 swaps) or quarterly (for portfolios containing no more than 50 swaps) basis. Any discrepancies in material terms arising from such reconciliations must be resolved "immediately" and any discrepancies in valuation must be resolved within one business day. Again, this one-day time frame for resolving valuation disputes is well outside even the aspirational goals of the existing OTC market.

Additionally, swap dealers and major swap participants must establish written policies and procedures regarding portfolio reconciliation with their counterparties that are not swap dealers or major swap participants. At a minimum, depending on the number of trades in the portfolio, these reconciliations must take place on a daily (for portfolios containing 500 or more swaps), weekly (for portfolios containing more than 100 but fewer than 500 swaps) or quarterly (for portfolios containing no more than 100 swaps) basis. The proposed rule does not set deadlines for reconciling any discrepancies that arise out of such reconciliations, but it does require any discrepancies to be resolved in accordance with written policies and procedures and in a "timely fashion."

We note that this portion of the proposed rule is a particularly significant departure from the current OTC market in which valuation disputes can go on for weeks or longer. The proposed rule does not seem consistent with the current ISDA initiative (undertaken at the behest of the New York Federal Reserve Bank and other financial regulators) to develop a new valuation dispute resolution procedure applicable to all market participants. The uncleared swaps that will presumably be subject to this portion of the proposed rule would include nonstandard trades for which valuation disputes are very technical and may be impossible to resolve within one day.

C. Portfolio compression. The third part of this proposed rule establishes portfolio compression requirements for swap dealers and major swap participants. The proposed rule would require swap dealers and major swap participants to participate in multilateral portfolio compression exercises prescribed by the CFTC, a self-regulating organization (SRO) or a DCO. Swap dealers and major swap participants would also be required to: (1) terminate bilaterally within one day all fully offsetting swaps that they have entered into with other swap dealers or major swap participants; (2) engage in bilateral compression activities on at least an annual basis with their counterparties that are swap dealers or major swap participants; and (3) maintain written policies and procedures for (a) terminating fully offsetting swaps that they have entered into with counterparties that are not swap dealers or major swap participants and (b) engaging in compression exercises for such swaps.

At this time, it is unclear whether or to what extent "limited" swap dealers would be required to participate in multilateral portfolio compression exercises prescribed by the CFTC, an SRO or a DCO.

A copy of the CFTC Proposed Rule on the confirmation, portfolio reconciliation and portfolio compression requirements for swap dealers and major swap participants is available at 75 Fed. Reg. 81519.
Comments on the proposed rule are due on February 28, 2011.

IX. External Business Conduct Rules

A. Current Treatment. Counterparties in the current OTC derivatives market generally address business conduct concerns by incorporating non-reliance provisions into their swaps that clarify the relationship between the parties. These provisions are often incorporated into a Schedule to the ISDA Master Agreement or in other master documentation (such as master repurchase agreements), or to a lesser extent, each confirmation to a swap. Such non-reliance provisions generally include representations that the party: (1) is acting on its own account and should seek an independent source of investment advice if such advice is needed; (2) is not relying on oral or written representations from the other party other than those set forth in the agreement; (3) understands the benefits and risks of the agreement and is able to assume such risks; and (4) is not acting as a fiduciary or as an adviser to the other party. SDs also usually distribute to their non-dealer counterparties standardized documentation setting forth the material characteristics, risks and conflicts of interest with respect to the swaps to be engaged in with their counterparties under an ISDA Master Agreement or other master documentation.

In effect, the non-reliance provisions may limit the liability of SD counterparties in swap transactions, and certain courts have interpreted such non-reliance provisions as a waiver of reliance even if the party relied on a previous oral statement. Since reliance is a required element of a common-law fraud or misrepresentation claim, the use of non-reliance provisions can diminish a party's ability to seek remedies under both Federal and State fraud claims.

B. Proposed Business Conduct Standards. *Verification of eligible contract participant status.* Pursuant to the D-F Act and the proposed rule, the CFTC will implement rules imposing duties upon SDs and MSPs to verify that each counterparty meets the eligibility standards to be an "eligible contract participant".[9] *Disclosure requirements.* SDs and MSPs must also disclose to each counterparty to a swap (other than an SD or MSP): (1) the material risks and characteristics of a swap (including a scenario analysis of potential exposure for an undefined class of "high risk complex bilateral swaps"[10] and for all swaps upon the election of a counterparty); (2) any material incentives or conflicts of interest that the SD or MSP may have with respect to the swap; and (3) upon the request of the counterparty for cleared or uncleared swaps, the daily mark of the swap. The proposed rule also requires SDs and MSPs to communicate in a fair and balanced manner with its counterparty based on principles of fair dealing and good faith. The proposed rule additionally prescribes standards to be followed by SDs and MSPs regarding: (1) fraud, manipulation, and other abusive practices involving swaps (including swaps that are offered but not entered into); (2) diligent supervision of the SD's and MSP's business; and (3) adherence to applicable position limits.

C. SIFMA and ISDA Comment Letter. On October 22, 2010, the Securities Industry and Financial Markets Association (SIFMA) and ISDA submitted to the CFTC a joint comment letter (Comment Letter) regarding the implementation of the foregoing business conduct standards for SDs and MSPs.[11] The Comment Letter included various suggestions to the CFTC regarding the new duties of SDs and MSPs related to disclosure and communication with counterparties.

Non-reliance revisited. The Comment Letter first requests that the CFTC encourage and sponsor the development and use of standardized disclosure materials regarding material risks, swap characteristics, material incentives and conflicts of interest. The Comment Letter also argues that the CFTC should clarify that the disclosure documentation: (1) can be satisfied on a relationship (rather than a transaction-by-transaction) basis in cases where prior disclosures apply to and adequately address the relevant transaction; and (2) do not apply to transactions executed by an SD or MSP on an exchange or SEF or otherwise in circumstances where the SD or MSP does not know the identity of its counterparty until immediately prior to (or after) execution. As discussed above, SDs currently distribute such standardized disclosure documentation to their non-dealer counterparties upon entering into master documentation with their counterparties (on a relationship basis), rather than including such documentation with each and every swap confirmation (on a transaction-by-transaction basis) unless the nature of the swap requires additional, transaction-specific disclosure. The Comment Letter urges the CFTC to allow this industry standard practice to continue with the implementation of new CFTC guidelines governing such disclosure documentation.

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[9] As defined in § 1a(12) of the Commodity Exchange Act. Under the D-F Act, OTC transactions with persons who are not eligible contract participants are not permitted.

[10] The CFTC identifies the characteristics of high-risk complex bilateral swaps to be the: (1) the degree and nature of leverage; (2) potential for periods of significantly reduced liquidity; and (3) the lack of price transparency.

[11] The Comment Letter is available here.

Daily marks. The Comment Letter also requests that the CFTC clarify that the requirement to disclose a "daily mark" for an uncleared swap transaction is intended only for the purpose of disclosing the basis for computing any margin call and is not intended to impose an obligation on registrants to perform valuation services for their counterparties. Further, the Comment Letter argues that the CFTC should admonish counterparties *not* to rely on their SD or MSP counterparties for the valuation of outstanding transactions and, instead, to perform their own valuations or utilize independent valuation resources. The Comment Letter also recommends that the CFTC endorse as a uniform market practice that parties agree to utilize a mid-market level for margin purposes. In the current OTC derivatives market, there is generally no requirement under swap documentation (such as the ISDA Master Agreement) requiring an SD to deliver any daily mark information to its counterparties. However, a counterparty may separately negotiate with the dealer for delivery of a valuation report showing the dealer's calculations in determining the valuation of swaps, margin calls or the return of collateral to the counterparty.

With respect to the fair and balanced communication requirement, the Comment Letter also suggests that the CFTC clarify that standards for communication by reference to the existing Financial Industry Regulatory Authority and National Futures Association standards currently used by SDs, subject to appropriate modifications to reflect the heightened standards for participation in the swap markets.

A copy of the CFTC Proposed Rule on external business conduct standards for swap dealers and major swap participants is available at 75 Fed. Reg. 80638. **Comments on the proposed rule are due on February 22, 2011.**

X. Position Limits

Section 737 of the D-F Act requires the CFTC to promulgate rules establishing position limits for futures and option contracts on commodities as well as for swaps that are economically equivalent to such futures or options. These position limits would apply to futures and options contracts on metals, energy commodities and agricultural commodities. The D-F Act requires the CFTC to establish position limits for metals and energy commodities within 180 days after enactment of the D-F Act (i.e., January 2010) and for agricultural commodities within 270 days after enactment of the D-F Act (i.e., April 2010).

Currently, the exchanges impose position limits and accountability levels for certain commodity futures and options but the CFTC does not impose any such limits. Swap transactions that are "economically equivalent" to commodity futures contracts or options are not currently subject to any position limits. Therefore, under the current regulatory framework, to the extent that a market participant exceeds position limits imposed by an exchange for a certain commodity, it can enter into an OTC swap transaction that mirrors the terms of a futures or options contract on that commodity. Once the CFTC promulgates rules establishing the position limits required by the D-F Act, these OTC transactions will no longer be a way for market participants to avoid position limits.

The CFTC considered a proposed rule on position limits at its open meeting on December 16, 2010, but decided to postpone voting on the proposed rule. The CFTC is now scheduled to consider a proposed rule on this issue at its open meeting scheduled for January 13, 2011.

The CFTC released a Fact Sheet and Q&A relating to its yet-to-be Proposed Rule on Position Limits after its December 16, 2010 open meeting. At this point, we do not know whether the proposed rule that the CFTC will consider on January 13, 2011 will be consistent with these releases.

Appendix A

CFTC Proposed Rules			
Proposed Rule	***Date Issued***	***Date Published***	***Comments Due***
Conflicts of Interest for DCOs, DCMs and SEFs	10/1/10	10/18/10	**11/17/10**
Definition of Agricultural Commodity	10/19/10	10/26/10	**11/26/10**
Position Reports for Physical Commodity Swaps	10/19/10	11/2/10	**12/2/10**
Removal of Reliance on Credit Ratings	10/26/10	11/2/10	**12/2/10**
Investment of Customer Funds	10/26/10	11/3/10	**12/3/10**
Financial Resource Requirements for DCOs	10/1/10	10/14/10	**12/13/10**
Disposal of Consumer Information	10/19/10	10/27/10	**12/27/10**
Privacy of Consumer Financial Information	10/19/10	10/27/10	**12/27/10**
Process for Review of Swaps for Clearing	10/26/10	11/2/10	**1/3/11**
Provisions Common to Registered Entities	10/26/10	11/2/10	**1/3/11**
Market Manipulation	10/26/10	11/3/10	**1/3/11**
Conflicts of Interest Policies and Procedures for FCMs and Introducing Brokers		11/17/10	**1/18/11**
Designation of Chief Compliance Officer	11/10/10	11/19/10	**1/18/11**
Foreign Boards of Trade	11/10/10	11/19/10	**1/18/11**
Conflicts of Interest Policies and Procedures for Swap Dealers and Major Swap Participants	11/10/10	11/23/10	**1/24/11**
Duties of Swap Dealers and Major Swap Participants	11/10/10	11/23/10	**1/24/11**
Registration of Swap Dealers and Major Swap Participants	11/10/10	11/23/10	**1/24/11**
Collateral Segregation for Uncleared Swaps	11/19/10	12/3/10	**2/1/11**

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<u>CFTC Proposed Rules</u>			
Whistleblower Incentives and Protection	11/10/10	12/6/10	**2/4/11**
Real Time Reporting of Swap Data	11/19/10	12/7/10	**2/7/11**
Swap Data Recordkeeping and Reporting	11/19/10	12/8/10	**2/7/11**
Reporting and Recordkeeping for Swap Dealers and Major Swap Participants	12/1/10	12/9/10	**2/7/11**
Procedures and Core Principles for DCOs	12/1/10	12/13/10	**2/11/11**
Reporting and Recordkeeping for DCOs	12/1/10	12/15/10	**2/14/11**
Entity Definitions *(Joint rulemaking with the SEC)*	12/1/10	12/21/10	**2/22/11**
Core Principles and Other Requirements for DCMs	12/1/10	12/22/10	**2/22/11**
External Business Conduct Standards for Swap Dealers and Major Swap Participants	12/9/10	12/22/10	**2/22/11**
Swap Data Repositories	11/19/10	12/23/10	**2/22/11**
End-User Exception to Mandatory Clearing	12/9/20	12/23/10	**2/22/11**
Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements for Swap Dealers and MSPs	12/16/10	12/28/10	**2/28/11**
Governance Requirements for DCOs, DCMs and SEFs	12/9/10		
Core Principles and Other Requirements for SEFs	12/16/10		
Risk Management Requirements for DCOs	12/16/10		

<u>CFTC Advanced Notices of Proposed Rulemaking</u>			
Treatment of Agricultural Swaps	9/21/10	9/28/10	**10/28/10**
Antidisruptive Practices	10/26/10	11/2/10	**1/3/11**
Collateral Segregation for Cleared Swaps	11/19/10	12/2/10	**1/18/11**

SEC Proposed Rules			
Proposed Rule	***Date Issued***	***Date Published***	***Comments Due***
Conflicts of Interest for DCOs	10/13/10	10/26/10	**11/26/10**
Market Manipulation	11/3/10	11/8/10	**12/23/10**
Whistleblower Provisions	11/3/10	11/17/10	**12/17/10**
Reporting and Disseminations of Security-Based Swap Information	11/19/10	12/2/10	**1/18/11**
Security-Based Swap Data Repositories	11/19/10	12/10/10	**1/24/11**
Entity Definitions *(Joint rulemaking with the CFTC)*	12/3/10	12/22/10	**2/22/11**
End-User Exception to Mandatory Clearing	12/15/10	12/21/10	**2/4/11**
Process for Review of Security-Based Swaps for Clearing	12/15/10		

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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