

# PUBLICATION

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## Commodity Futures Trading Commission Adopts Final Rules Regulating Swaps Markets

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On January 11, 2012, the U.S. Commodity Futures Trading Commission (CFTC) adopted regulations aimed at providing additional protections for the swaps market, including a rule requiring firms to segregate customers' collateral for cleared swaps, a rule requiring registration of swap dealers and major swap participants and a rule setting standards for external business conduct with counterparties. These rules are the latest to be adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act.

### Background

On July 21, 2010, President Obama signed the Dodd-Frank Act into law. Title VII of Dodd-Frank amended the Commodities Exchange Act to establish a comprehensive new regulatory framework for swaps and certain security-based swaps. This legislation is intended to reduce risk, increase transparency and promote market integrity within the financial system by, among other things:

1. Providing for the registration and comprehensive regulation of swap dealers and major swap participants;
2. Imposing mandatory clearing and trade execution requirements on clearable swap contracts;
3. Creating rigorous recordkeeping and real-time reporting regimes; and
4. Enhancing the CFTC's rulemaking and enforcement authorities with respect to, among others, all registered entities and intermediaries subject to the CFTC's oversight.

Within the framework of Title VII, Congress included provisions on the treatment of cleared swaps customer contracts and collateral, the registration of swap dealers and major swap participants, and business conduct standards for swap dealers and major swap participants dealing with counterparties. The CFTC's final rules were adopted pursuant to these provisions.

### The Segregation Rule

The segregation rule adopted by the CFTC sets forth the rules and procedures for protecting collateral posted by cleared swaps customers. Specifically, it implements Section 724 of the Dodd-Frank Act, which establishes standards for treatment of cleared swaps and related collateral. Section 724(a) amended the Commodities Exchange Act by inserting new section 4d(f), which requires each futures commission merchant (FCM) and derivatives clearing organization (DCO) to (1) hold cleared swaps customer collateral in an account that is separate from the property belonging to the FCM or DCO and (2) not use the collateral of one cleared swaps customer to cover the obligations of another customer or of the FCM.

In accordance with these provisions, the CFTC adopted the Legally Segregated Operationally Commingled (LSOC) Model, which requires that cleared swaps customer collateral be segregated from the FCM's own property but permits the collateral to be kept pre-bankruptcy in one account. In addition, the LSOC Model requires information about customers' portfolios to be sent to the applicable clearing organization(s) at least once a day. In the event of a default by both a clearing member FCM and one or more of the clearing member's swaps customers, a DCO would not have recourse to the collateral posted by non-defaulting cleared

swaps customers. Rather, the DCO would only have recourse against the collateral of the defaulting customers and against the clearing member itself. To the extent applicable, these regulations parallel the rules governing the segregated accounts in which FCMs currently hold futures customer collateral.

## The Registration Rules

The registration rules establish a registration process for swap dealers and major swap participants in accordance with the registration requirements set forth under the Dodd-Frank Act. Pursuant to Section 731 of Dodd-Frank, the rules require all swap dealers and major swap participants to be registered with and remain members of a registered futures association. Notably, persons associated with the swap dealers and major swap participants are not required to register. However, subject to some limitations, the final regulations prohibit any swap dealer or major swap participant from permitting any person associated with it who is subject to a statutory disqualification to be involved in effecting swaps, assuming the dealer knows or should have known of the disqualification.

Ultimately, registration will subject swap dealers and major swap participants to additional requirements. Registered swap dealers and major swap participants must meet specific obligations with regard to, among other things:

5. Capital and margin;
6. Reporting and recordkeeping;
7. Daily trading reports;
8. Business conduct standards;
9. Documentation standards;
10. Trading duties;
11. Designation of chief compliance officer; and
12. Segregation of customer funds

The CFTC is currently engaged in separate rulemaking with respect to these requirements.

In conjunction with these registration rules, the CFTC has been directed to adopt regulations defining "swap," "swap dealer" and "major swap participant." The CFTC is currently in the process of finalizing regulations defining these terms. Registration will not be mandatory until the Swap Definitional Regulations are finalized and effective. Prior to that time, persons who believe that they are swap dealers or major swap participants will be able – but not required – to register with the CFTC.

Parties that are considering current or future registration should review the proposed definitions of swap dealer and major swap participant. The proposed rules indicate the definition of "swap dealer" means persons who enter into swaps to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties.

The proposed rule suggests that to be considered a "major swap participant," a person must meet several tests. Most applicable is a person "[w]hose 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 final rule will most likely set numeric limits around the \$1 billion mark.

Parties that do not fall within the definitions of swap dealer or major swap participant will be exempt from the registration requirements.

## External Business Conduct Standards

Pursuant to Section 731 of Dodd-Frank, the CFTC is required to promulgate rules to establish business conduct standards for swap dealers and major swap participants dealing with counterparties. Generally speaking, the final rules require swap dealers and major swap participants to engage in fair dealing, make disclosures of material information and undertake due diligence with respect to their counterparties. The general provisions contain prohibitions against fraud, manipulation and abusive practices and protect confidential counterparty information. Moreover, the rules require disclosure of the material risks and characteristics of a swap and the material incentives and conflicts of interest of a swap dealer or major swap participant in connection with a swap. Also included is an institutional suitability rule that applies when swap dealers make recommendations to counterparties as well as a rule that communication to counterparties be based on principles of fair dealing and good faith. The final rules impose heightened duties with respect to some entities such as municipal entities and pension plans.

In response to concerns expressed by commenters, the regulations confirm, among other things, that the final standards do not cause swap dealers or major swap participants to be advisors or otherwise owe fiduciary duties to counterparties solely by virtue of compliance with the rules. Moreover, the rule excludes swap dealers from the definition of "commodity trading advisor" under certain circumstances and ensures that a swap dealer or major swap participant will not become an ERISA fiduciary under existing ERISA law through compliance with these provisions.

### **Next Steps**

As mentioned above, the CFTC continues to engage in the rulemaking process that will ultimately complete the regulatory scheme envisioned by Dodd-Frank. Important issues that are germane to existing regulations, including basic definitions, have not been addressed, making it unclear how the rules will affect various market participants. Chairman Gary Gensler hopes to finalize definitional rules issued jointly with the SEC – including rules defining "swap dealer" and "major swap participant" – in the first quarter of 2012 and considers additional rules, such as rules governing internal business conduct standards, as likely topics for consideration in the same time frame. Likewise, Chairman Gensler is hopeful that proposals regarding the extraterritorial application of Dodd-Frank, among other topics, can be issued in early 2012.

Debate is ongoing regarding a potential regulatory response to the collapse of futures firm MF Global Holdings, Ltd. Specifically, the CFTC is considering additional regulations aimed at protecting the swaps market and indicated that these protections could be extended to the futures markets. Indeed, Commissioner Jill Sommers, the lone dissenter on the segregation rules, objected in part that the protections offered by the regulations to swap customers do not extend to futures customers.

If you have questions about how these issues might affect your company, or have any other securities or commodities-related issues, please contact your Baker Donelson attorney.