

June 17, 2011

CFTC, SEC Propose to Delay the Applicability of Certain Swap Provisions of the Dodd-Frank Act

The general effective date for most provisions under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") that do not require rulemaking is July 16, 2011. As this date approaches, and many final rulemakings by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") will not be in place as of July 16, 2011, market participants have become increasingly concerned with the legal uncertainty created by the effectiveness of a new regulatory regime without finalized rules and regulations. To address these concerns, and to avoid undue disruptions of the swaps markets during the transition to a new regulatory framework, the CFTC and the SEC, on June 14 and June 15, 2011, respectively, issued temporary exemptive relief¹² to swap market participants from various requirements under the Commodity Exchange Act (the "CEA") and the Securities Exchange Act of 1934 (the "Exchange Act"), as amended by the Dodd-Frank Act, that would otherwise apply to certain swap and security-based swap transactions as a result of the Dodd-Frank Act generally becoming effective on July 16, 2011.

Background

The effective date for most of the Dodd-Frank Act's provisions is the later of (i) July 16, 2011 (360 days following the date of enactment) or (ii) 60 days following the publication of relevant final rules or regulations required under the Dodd-Frank Act.³ Since the enactment of the Dodd-Frank Act, the Commissions have proposed rules to implement many of its swap-related requirements. However, a majority of the required rules and regulations will not be finalized by July 16, 2011. In accordance with the authority granted to the Commissions under the Dodd-Frank Act, the CEA and the Exchange Act,⁴ the Commissions propose to provide legal certainty in the form of temporary exemptive relief from the impact of certain provisions of the Dodd-Frank Act until December 31, 2011 or until a final rule becomes effective. The relief is necessary because certain provisions of the Dodd-Frank Act that take

¹ Notice of Proposed Order and Request for Comment (the "CFTC Order"), 76 Fed. Reg. 35372 (June 17, 2011).

² Order Pursuant to Sections 15F(b)(6) and 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, and Request for Comment (the "SEC Order," and together with the CFTC Order, the "Orders") published by the SEC on June 15, 2011, available at <http://sec.gov/rules/exorders/2011/34-64678.pdf>.

³ See sections 754 and 774 of the Dodd-Frank Act.

⁴ See section 712(f) of the Dodd-Frank Act, section 4(c)(1) of the CEA, 7 U.S.C. § 1 *et seq.* and section 36 of the Exchange Act, 15 U.S.C. § 78a *et seq.*, as applicable.

effect on July 16, 2011 reference terms that require further rulemaking by the Commissions, and because certain exemptions and exclusion that market participants currently rely on for their swap transactions will be repealed effective July 16, 2011.

Scope of Exemption Proposed by the CFTC

The CFTC Order provides temporary relief in relation to two types of provisions of the Dodd-Frank Act: (1) self-effectuating provisions that reference terms requiring definitional rulemakings and (2) self-effectuating provisions that repeal certain provisions of current law. The proposed exemptive relief will not apply to provisions of the Dodd-Frank Act that require a rulemaking (as such provisions are not self-effectuating and will not take effect until at least 60 days after the relevant final rule is published) or any self-effectuating provisions of the Dodd-Frank Act that do not require relief.⁵ Further, the exemptions in the CFTC Order do not apply to futures contracts, options on futures, or transactions by retail customers in foreign currency or other commodities.

Self-Effectuating Provisions Referencing Terms Requiring Further Definition – Certain provisions of the Dodd-Frank Act that will become effective on July 16, 2011 reference terms that are subject to further rulemakings (i.e. “swap,” “swap dealer,” “major swap participant,” and “eligible contract participant”).⁶ As these definitional rulemakings will not be finalized by July 16, 2011, the CFTC proposes to exempt market participants from complying with provisions of the CEA (as added or amended by the Dodd-Frank Act) to the extent such provisions specifically relate to terms awaiting further definitional rulemakings. The proposed exemptions expire upon the earlier of the effective date of a final definitional rule or December 31, 2011.

Self-Effectuating Provisions Repealing Exemptions and Exclusions in the CEA – Currently, the CEA provides for the exclusion or the exemption of certain transactions between eligible parties in financial and other non-agricultural commodities (such as metals, chemicals and energy) from CFTC oversight. Many of these exemptions have been added to the CEA by the Commodity Futures Modernization Act of 2000 (the “CFMA”).⁷ As of July 16, 2011 these exclusions and exemptions will be repealed, thereby raising the specter of legal uncertainty and unenforceability of transactions entered into in reliance on these exemptions. However, other established regulatory exemptions and safe harbors, most notably the CFTC’s Swap Policy Statement,⁸ and Parts 32 and 35 of the CFTC regulations⁹ continue to be available to transactions that meet the conditions therein until such policies and regulations are repealed or replaced. The Swap Policy Statement essentially states that cash-settled,

⁵ Lists of these provisions prepared by the CFTC staff have been published on the CFTC’s website at http://www.cftc.gov/PressRoom/Events/opaevent_cftcdoddfrank061411.html.

⁶ See sections 712(d) and 721(c) of the Dodd-Frank Act.

⁷ See sections 2(d), 2(g), 2(h) 2(e) and 5(d) of the CEA.

⁸ See Commodity Futures Trading Commission, Statement of Policy Concerning Swap Transactions, 54 Fed. Reg. 30694 (July 21, 1989) (the “Swap Policy Statement”).

⁹ See 17 C.F.R. Part 32 (“Part 32”) and 17 C.F.R. Part 35 (“Part 35” or “Swap Agreement Exemption”).

non-cleared swap agreements with individually negotiated terms entered into by each party in conjunction with the party's line of business are not subject to the trading restrictions in the CEA.¹⁰ The Swap Agreement Exemption provides a broad-based exemption for bilateral, non-standardized and non-cleared swap agreements between eligible swap participants.¹¹ In many, though not all, respects, however, the Swap Agreement Exemption is narrower than the exemptions introduced by the CFMA. To compensate for the repeal of the broader exemptions under the CEA on July 16, 2011, the CFTC, in its Order, expands the scope of the Swap Agreement Exemption and extends temporary relief from the CEA to transactions that may fail to satisfy one or more prongs of the Swap Agreement Exemption but otherwise fall within the scope of the CEA exemptions (as in effect prior to July 16, 2011). This exemptive relief is available until the earlier of the repeal or replacement of Part 32 or Part 35 of the CFTC regulations or December 31, 2011.

The CFTC Order does not apply to any provision of the Dodd-Frank Act that has already become effective or any provision of the Dodd-Frank Act that may become effective after July 16, 2011. The Order does not affect the CFTC's authority with respect to any of the anti-fraud or anti-manipulation provisions of the CEA (as amended by the Dodd-Frank Act) and does not prevent the CFTC from issuing any future orders further delaying the effective dates of any provisions of the Dodd-Frank Act.

Scope of SEC Exemptions

The SEC recognizes that market participants will need to configure and modify existing practices and systems to comply with the new regulatory framework and that some of these changes cannot be finalized until certain rules, which will not be in place prior to July 16, 2011, are effective. The SEC Order takes a more rules-based approach than the CFTC Order and grants temporary exemptive relief from the requirements of specific provisions of the Exchange Act (as amended by the Dodd-Frank Act) to allow market participants additional time to comply with the Dodd-Frank Act and related rules.

Reporting of Pre-Enactment Security-Based Swaps – The SEC Order temporarily exempts any person required to report any pre-enactment security-based (“SB”) swap to a registered SB swap data repository (“SDR”) or the SEC (pursuant to section 3C(e)(1) of the Exchange Act) from such requirement. This exemption is available until six months after any SDR capable of accepting information relating to SB swaps is registered with the SEC, thereby allowing market participants additional time to establish connectivity and develop appropriate policies and procedures for the delivery of information to registered SDRs.

Clearing Election – As of July 16, 2011, at the election of a counterparty to an SB swap that is not subject to the mandatory clearing requirements, SB swap dealers and major SB swap

¹⁰ See *supra* note 8, at I. (“[I]t is the CFTC’s view that ... most swap transactions ... are not appropriately regulated as [futures] under the [CEA] and regulations.”); *supra* note 8, at II. (“[T]he CFTC has determined that a greater degree of clarity may be achieved through safe harbor guidelines establishing specific criteria for swap transactions to which the [CFTC’s] regulatory framework will not be applied.”)

¹¹ See 17 C.F.R. 35.2.

participants would be required to clear such SB swaps.¹² The SEC Order postpones such clearing requirement until the earliest compliance date set forth in any of the final rules regarding the SEC's determination that any SB swap should be required to be cleared.¹³

Chief Compliance Officers – The SEC Order exempts registered clearing agencies from designating an individual to act as chief compliance officer until the duties of such chief compliance officer are more certain. This exemption expires on the earliest compliance date set forth in any final rules relating to the duties of chief compliance officers under the provisions of the Dodd-Frank Act.¹⁴

Security-Based Swap Execution Facility Registration – Section 3D(a)(1) of the Exchange Act (as amended by the Dodd-Frank Act) prohibits any person from operating a facility for the trading or processing of SB swaps after July 16, 2011 unless the facility is registered as an SB swap execution facility ("SEF") or a national securities exchange. Due to the fact that SB SEF registration requirements have not yet been promulgated by the SEC, the SEC Order postpones such registration requirement until the earliest compliance date in any final rules regarding the registration of SB SEFs.

National Securities Exchange/SB SEF Identification of Electronic Trades – The SEC Order exempts national securities exchanges, to the extent they also operate as SB SEFs, from the requirement to identify whether electronic trading of SB swaps is taking place through the national securities exchange or the SB SEF.¹⁵ This exemption expires upon the effective date of any final rules regarding the registration of SB SEFs.

Initial Margin Segregation – As of July 16, 2011, at the request of a counterparty to an uncleared SB swap, SB swap dealers and major SB swap participants would be required to segregate any initial margin delivered by such counterparties in connection with any SB swap.¹⁶ The SEC Order postpones such segregation requirement until final rules regarding the registration of SB swap dealers and major SB swap participants become effective.

Security-Based Swap Data Repositories – The SEC Order exempts SB SDRs from certain provisions of the Exchange Act imposing obligations on SB SDRs¹⁷ until the earlier of (i) the

¹² See section 3C(g)(5)(B) of the Exchange Act.

¹³ See section 3C(b) of the Exchange Act.

¹⁴ See section 3C(j)(2) of the Exchange Act.

¹⁵ See section 3D(c) of the Exchange Act.

¹⁶ See section 3E(f) of the Exchange Act.

¹⁷ See sections 13(n)(5)(D)(i) (requiring an SDR to provide direct electronic access to the SEC or any designee of the SEC), 13(n)(5)(F) (requiring an SDR to maintain the privacy of any and all SB swap transaction information that the SDR receives from an SB swap dealer, counterparty or other registered entity), 13(n)(5)(G) (requiring that a SDR on a confidential basis, and after notifying the SEC of the request, make available all data obtained by the SDR, including individual counterparty trade and position data, to certain enumerated entities), 13(n)(5)(H) (requiring that an SDR, before sharing information with any of the entities listed in section 13(n)(5)(G) of the Exchange Act, (i) receive a written agreement from such entity that the entity will abide by certain confidentiality provisions relating to the information on SB swap transactions that is provided and (ii) each such entity shall agree to indemnify the SDR and the SEC for any expenses arising from litigation relating to the information provided), and 13(n)(7)(A) through (C) (prohibiting an SDR from adopting any rule or taking any action that results in any unreasonable restraint

date that the SEC grants registration to an SB SDR and (ii) the earliest compliance date for final rules regarding the registration of SB SDRs. This temporary exemption provides SB SDRs with additional time to develop the policies, procedures and systems to implement the obligations imposed by the Dodd-Frank Act.

Statutory Disqualification of Persons Associated With Certain Registered Entities – As of July 16, 2011, SB swap dealers and major SB swap participants would be prohibited from permitting an associated person subject to a statutory disqualification¹⁸ to effect or be involved in effecting SB swaps on behalf of the SB swap dealer or major SB swap participant if such entity knew or should have known of the statutory disqualification.¹⁹ The SEC is expressly authorized to establish exceptions to this provision of the Exchange Act.²⁰ The SEC Order allows persons subject to statutory disqualification who are currently associated with an SB swap dealer or major SB swap participant and effecting SB swaps on behalf of such entity to continue to be associated with such entity until the rules adopted by the SEC for the registration of SB swap dealers and major SB swap participants become effective.

Eligible Contract Participants – Pursuant to section 6(l) of the Exchange Act, as of July 16, 2011, it will be unlawful for any person to enter into an SB swap with or for a person that is not an “eligible contract participant” (as amended by the Dodd-Frank Act)²¹ unless such transaction is effected on a registered national securities exchange. Comments received by the SEC expressed concern that market participants may refuse to enter into SB swaps with counterparties that could potentially fall outside the scope of the amended definition of “eligible contract participant.” The SEC Order exempts persons meeting the definition of “eligible contract participant” as such definition existed prior to the enactment of the Dodd-Frank Act from the prohibitions of section 6(l) of the Exchange Act until final rules further defining the term “eligible contract participant” are effective.

Contracts Void for Violations of the Exchange Act – The Exchange Act provides for the avoidance of contracts made in violation of the Exchange Act.²² The SEC takes the view that the provisions of the Exchange Act triggered by registering with the SEC, upon the adoption of final rules by the SEC, or for which the SEC has provided an exemption will not require compliance as of July 16, 2011. For the avoidance of doubt, until such date specified by the SEC, the SEC Order temporarily exempts any SB swap entered into on or after July 16, 2011 from being void or voidable under the Exchange Act because a party to the SB swap violated a provision of the Exchange Act that was amended or added by the Dodd-Frank Act and for which the SEC has taken the view that such provision was not effective as of July 16, 2011.

of trade or impose any material anticompetitive burden on the trading, clearing, or reporting of transactions; requiring that SDRs establish transparent governance arrangements for certain enumerated reasons; and requiring that SDRs establish rules to minimize conflicts of interest and establish a process for resolving conflicts of interest) of the Exchange Act.

¹⁸ As defined in section 3(a)(39) of the Exchange Act.

¹⁹ See section 15F(b)(6) of the Exchange Act.

²⁰ *Id.*

²¹ See section 721(a) of the Dodd-Frank Act amending section 1(a)(18) of the CEA.

²² See section 29(b) of the Exchange Act.

Looking Forward

Comments on the CFTC Order must be received by the CFTC on or before July 1, 2011. The CFTC has expressed its desire to issue a final order at the scheduled July 7, 2011 CFTC meeting. Comments on the SEC Order must be received by the SEC on or before July 6, 2011. The SEC intends to separately address requests for exemption from certain provisions of the Exchange Act that will impose new obligations on counterparties to SB swaps as a result of the incorporation of SB swaps into the definition of "security" under the Exchange Act as amended by the Dodd-Frank Act.²³

The Orders aim to prevent participants in the over-the-counter derivatives markets from having to alter their established practices while the Commissions finalize their rulemakings. The temporary relief granted in the Orders is intended to provide the legal certainty market participants have been requesting ahead of the general effective date of the Dodd-Frank Act on July 16, 2011. There is, however, a risk of continued uncertainty. The CFTC Order limits the exemptive relief to a fixed period of approximately six months. The CFTC believes temporary relief from the requirements of the Dodd-Frank Act is appropriate to allow for additional rulemakings and periodic review of the scope and extent of exemptive relief and ensure such relief is appropriately tailored to the sequence of implementation of final rules under the Dodd-Frank Act. The CFTC recognizes the need to move expeditiously to finalize the required rules.²⁴ Until such rules are finalized, however, market participants face continued uncertainty and in November of 2011 may find themselves in the very same position as they do today. In addition, much of the relief granted by the CFTC is premised on reliance on established pre-CFMA exemptions and safe harbors. The Swap Agreement Exemption in Part 35 of the CFTC regulations, however, is itself subject to a proposed rulemaking that calls for the repeal of Part 35 to ensure it is not used by market participants as a means to circumvent the new requirements under the Dodd-Frank Act.²⁵ Without more guidance from the Commissions on an anticipated implementation timeline for final rules, the market has no certainty as to the availability and expiration of the relief granted by the Orders.²⁶

²³ See section 761(a)(2) of the Dodd-Frank Act amending section 3(a)(10) of the Exchange Act. The Orders also discuss the Commissions' scope of authority to grant relief from the requirements of the Dodd-Frank Act and state that the Commissions will use other available authority to provide appropriate temporary relief if necessary to ensure a smooth transition to the new regulatory framework.

²⁴ See Opening Statement by Commissioner Bart Chilton available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement061411b.html>.

²⁵ Notice of Proposed Rulemaking, 76 Fed. Reg. 6095 (February 3, 2011).

²⁶ See Opening Statement by Commissioner Scott O'Malia available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement061411.html>.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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