

Dodd-Frank Derivatives Implementation: If Not Now, When?

By Annette Nazareth and Gabriel D. Rosenberg

The Dodd-Frank Act, signed into law on July 21, 2010, outlined an ambitious plan for the implementation of its comprehensive reform of the over-the-counter derivatives market. The derivatives provisions were due to go into effect—and the vast majority of the implementing regulations were due to be finalized—by 360 days after the law was signed on July 16, 2011. Yet, over the past year, the Commodity Futures Trading Commission and the Securities and Exchange Commission have each delayed the effectiveness of Dodd-Frank's derivatives provisions and fewer than 20% of the rules with a July 2011 deadline have been finalized. The Dodd-Frank schedule has proven far too ambitious, leaving market participants to wonder when there will be certainty concerning the regulatory requirements and when they will have to comply. On Sept. 9, the regulators took the first concrete step towards offering needed certainty through an implementation timeline, with the CFTC proposing a general phase-in schedule for clearing, exchange trading, documentation and margin requirements.

When fully implemented, Dodd-Frank's derivatives reform will subject previously unregulated swaps, including interest rate swaps, commodity swaps, swaps on broad-based securities indices and a limited number of foreign exchange swaps, to the CFTC's jurisdiction. Swaps on single or narrow-based indices of securities will be subject to the SEC's jurisdiction. Swap dealers—the liquidity providers in the swap market—and major swap participants—those few very large non-dealers who pose systemic risk by their swap activities—will become subject to registration and comprehensive regulation, including capital, margin, internal and external business conduct, and reporting and recordkeeping requirements. Standardized swaps will need to be centrally cleared and traded on an exchange or a "swap execution facility," making

the trading of these instruments more akin to exchange-traded futures. Most uncleared bilateral swaps will be subject to higher levels of initial and variation margin. Swap market participants will face collateral segregation requirements and large-trader reporting as well as position limits. In short, the changes to the swap markets will be significant and comprehensive. With so many statutory rule-making deadlines missed, the timeframe for implementation of and compliance with these changes remains fluid and unclear. Nevertheless, the regulators have started to put forward their estimates for completion of the rulemaking process. At a meeting on Sept. 9, the CFTC announced the draft rule finalization schedule in Figure 2. The SEC's rulemaking process is likely to take longer; unlike the CFTC, the SEC has a number of key rule-makings yet to be proposed, including rules on capital requirements for security-based swap dealers and major security-based swap

participants as well as margin requirements for uncleared security-based swaps.

Once rules are finalized, the implementation clock will begin to tick. Dodd-Frank sets no outside time limit for rule compliance, instead instructing the CFTC and SEC that all sections requiring rules cannot become effective until two months have passed after rules are finalized. In practice, implementation periods are likely to be significantly longer than this 60-day statutory minimum, to allow for new business procedures and technological and operational builds, among many other changes.

Though not contemplated by Dodd-Frank, there has recently been significant momentum behind a push to implement these derivatives provisions in phases based on the type of market participant. During a joint CFTC-SEC roundtable on implementation in May 2011 and in subsequent comments to the two agencies,

FIGURE 1 CFTC and SEC Progress

CFTC and SEC progress on derivatives rulemakings as of Sept. 18, 2011

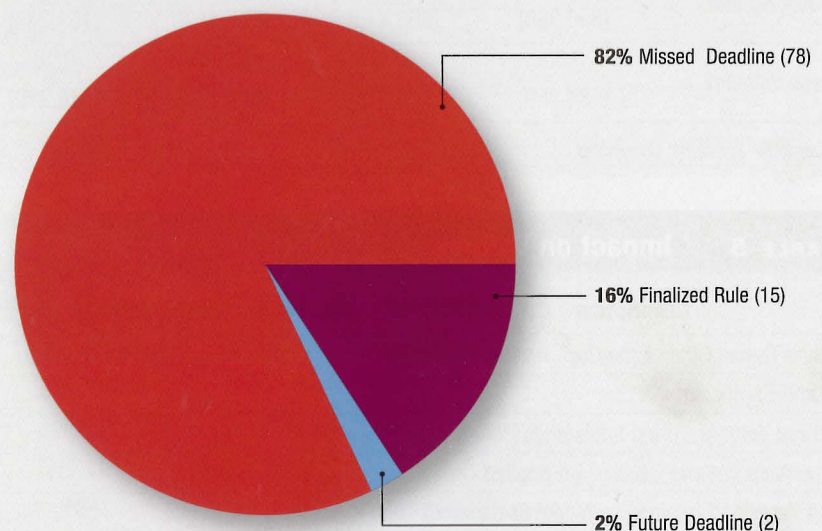
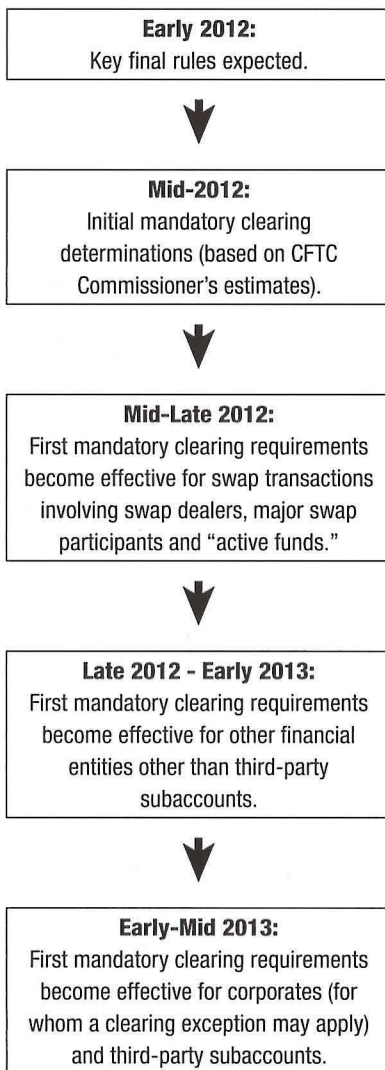


Figure 2: CFTC Proposed Schedule for Finalization of Title VII Rules

Remainder of 2011:
Clearinghouse Rules
Data Recordkeeping and Reporting
End-User Exception
Entity Definitions/Registration
External Business Conduct
Internal Business Conduct (Duties, Recordkeeping and Chief Compliance Officers)
Position Limits
Product Definitions/Commodity Options
Real-Time Reporting
Segregation for Cleared Swaps
Trading – Designated Contract Markets and Foreign Boards of Trade
First Quarter 2012:
Capital and Margin
Client Clearing Documentation and Risk Management
Conforming Rules
Disruptive Trading Practices
Governance and Conflict of Interest
Internal Business Conduct (Documentation)
Investment of Customer Funds
Swap Execution Facilities
Segregation for Uncleared Swaps
Straight-Through Trade Processing

Figure 3: Possible Clearing Timeline, Based on CFTC Proposal



Dodd-Frank requirements, such as centralized clearing, which will likely be more closely aligned with G-20 commitments than previously thought. Dodd-Frank allows the CFTC and the SEC to require that a swap be cleared either on the Commission's own initiative or if a clearinghouse seeks approval to clear a swap. If the review is initiated by a clearinghouse, the regulator has 90 days to make its determination. With clearinghouses likely to begin submissions in the next several weeks, CFTC Chairman Gary Gensler has predicted that the CFTC's first mandatory clearing determinations will be made in late first quarter or early second quarter of 2012 and CFTC Commissioner Scott O'Malia has predicted that mandatory clearing determinations will begin in the third quarter of 2012. Layering onto these estimates the CFTC's implementation proposal, it is possible that mandatory clearing of even the most standardized interest rate and credit default swaps will not begin for swap dealers, major swap participants and active funds until the summer or fall of 2012, for other financial entities until the fall or winter of 2012 and for third-party subaccounts and non-exempt corporates until 2013.

Any swap that is required to be cleared will have to be traded on an exchange or swap execution facility, if such a facility "makes the swap available to trade." As a result, the CFTC's proposed timeline for clearing also applies to these mandatory trading requirements, with the caveat that no swap will be required to meet the trade execution requirement until 30 days after the first facility makes the swap available for trading.

Until rules are finalized and implementation dates are certain, market participants will remain in the difficult position of having to plan for complex, but unknown, changes. As a result, actions like the CFTC's proposed implementation rule and the additional guidance that is likely to follow in the coming weeks, serve a vital purpose in helping the market plan for and cope with the post-Dodd-Frank derivatives world.

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market participants have argued that initial Dodd-Frank compliance will be most manageable for large financial institutions with significant trading infrastructure and more difficult for smaller financial institutions and corporates.

The CFTC appears to agree with these comments. On Sept. 9, the CFTC proposed an implementation schedule for clearing, exchange trading, documentation and margin requirements that, at the CFTC's discretion, would implement each of these requirements in three phases once certain key rules, including definitional rules, are finalized. Active swap market participants—swap dealers, major swap participants and "active funds"—would need to comply with

any given clearing, margin or documentation requirement within 90 days of its finalization. Other financial entities, apart from third-party managed subaccounts, would have 180 days to comply. Corporates and third-party managed subaccounts would have the longest period—270 days. Exchange trading would not be required until the later of either the mandatory clearing phase-in period or 30 days after the swap is "made available for trading." The SEC has yet to formally speak on implementation timelines, but will likely do so soon.

The CFTC's recent pronouncements—and related comments by CFTC Commissioners—begin to paint a picture of market compliance with some of the most important