

CFTC and SEC Act to Defer Dodd-Frank Swaps Requirements

The CFTC and SEC took actions this week that are expected to defer most Dodd-Frank requirements regulating swaps and security-based swaps (“**SBS**”) that would otherwise have gone into effect on July 16, 2011. The SEC granted temporary relief, and the CFTC proposed to grant temporary relief, to market participants from the majority of these requirements. In doing so, the CFTC and SEC provided swap and SBS market participants with much-needed certainty. The CFTC’s proposal is subject to a 14-day public comment period. The SEC’s order is effective immediately, although public comment is requested. Both agencies have signaled that further relief is likely to be forthcoming. The SEC’s release is [available here](#) and the CFTC’s release is [available here](#).

Background

Dodd-Frank’s swap and SBS provisions generally become effective on the later of July 16, 2011 or, if the provision requires rulemaking, no earlier than 60 days after the publication of the final rule in the Federal Register. The statute requires the CFTC and SEC to finalize most required rules by July 16. However, to date, the CFTC and SEC have issued very few final rules, and none of the key rules have been finalized, including those defining “swap,” “security-based swap,” “mixed swap,” “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant” and “eligible contract participant.”

Many swaps and SBS provisions clearly require rulemaking to become effective. Other provisions clearly do not require rulemaking to become effective. However, until this week, the effective dates of a significant number of provisions have been unclear.

CFTC Guidance and Proposed Relief

The CFTC categorized Dodd-Frank swap provisions into four categories.

Category 1 – Rulemaking Required, No Relief

Category 1 provisions require rulemaking. With respect to this category, the CFTC provides no relief and points out that it can implement the provisions pursuant to a phased-in approach. A preliminary list of provisions falling into this category was published by the CFTC and is [available here](#).

Category 2 – Provision Incorporates Terms That Need to Be Defined Further, Effectiveness Deferred

Category 2 provisions incorporate terms that the CFTC must further define, including “swap,” “swap dealer,” “major swap participant” and “eligible contract participant.” While the CFTC and SEC have jointly proposed further definitions of these terms, the definitions have not been finalized, leading to market confusion as to how to comply with provisions that refer to these terms. As a result, the CFTC has proposed to use its exemptive authority to delay the requirements in most of these provisions until the earlier of the date that the rules defining these terms go into effect and December 31, 2011, a date that may yet be postponed. This relief includes, for example, the provision that swaps with non-eligible contract participants must be traded on a designated contract market. In several cases where the CFTC believes that it does not have statutory authority to grant exemptions, the CFTC has indicated that its staff may provide no-action relief. This relief may be useful for the segregation requirements for noncleared swaps and the requirement that swap dealers and major swap participants have to designate a chief compliance officer, among others.

Chairman Gary Gensler recently stated publicly that the CFTC intends to finish all rulemaking by the end of this year. The CFTC is likely to extend the December 31 deadline if its rules are not effective at that time. It is unlikely that the rules will be effective by December 31, as the 60-day effectiveness waiting period would require final rules to be published by November 1.

Category 3 – Legal Certainty Provisions, Relief Granted

Category 3 provisions are those through which Dodd-Frank repeals provisions that were added to the Commodity Exchange Act (“CEA”) by the Commodity Futures Modernization Act of 2000 (“CFMA”). These provisions provided legal certainty that swap contracts, particularly those referencing excluded or exempted commodities, were not subject to the CEA, including the requirement that all futures contracts must be transacted on an exchange. When fully effective, swaps and the market participants engaged in transacting in them will be subject to a comprehensive regulatory regime under the CEA. Pending effectiveness of Title VII’s provisions, however, there is concern that contracts previously protected by the CFMA could be challenged as illegal, off-exchange futures contracts.

To solve this problem temporarily, the CFTC notes that its existing regulatory exemptions for non-standardized, non-cleared, non-exchange traded transactions (contained in Part 35 of the CFTC’s rules) and commodity option transactions (contained in Part 32 of the CFTC’s rules) remain in effect after July 16. In addition, the CFTC is providing a temporary exemption from most provisions of the CEA for transactions in exempt or excluded commodities that would not meet certain of the Part 32 or Part 35 requirements, as modified by the order, but would have fallen under CEA sections 2(d), 2(e), 2(g), 2(h) or 5d, or the line of business exemption, before Dodd-Frank’s effectiveness. This temporary exemption lasts until the earlier of the date on which Part 32 or Part 35, as applicable, is repealed or December 31, 2011.

Category 4 – Effective on July 16, No Relief Granted

Category 4 provisions are those that are self-effective on July 16 but for which the CFTC has decided not to provide relief. The CFTC provided a list of these provisions, [available here](#), which include:

- self-effective CEA provisions added by Dodd-Frank that do not refer to “swap,” “swap dealer,” “major swap participant” or “eligible contract participant,” including provisions related to core principles for designated contract markets and derivatives clearing organizations and disruptive trading practices;
- numerous existing and future antifraud and antimanipulation authorities and rules for transactions other than swaps (including, but not limited to, futures contracts, options on futures contracts, transactions with retail customers in foreign currency or other commodities and transactions subject to exemptive relief through Category 3);
- rules related to futures, options on futures or retail transactions in foreign currencies or other commodities; and
- any Dodd-Frank provision that already has become effective, such as pre-enactment swap reporting.

SEC Guidance and Relief

The SEC provided guidance in an order issued on June 15 (the “SEC Order”) as to which provisions will be effective on July 16 and, effective immediately, granted temporary exemptive and other relief, on a provision-by-provision basis, from the majority of requirements that would otherwise become effective on July 16.

Guidance on the Provisions that Are Self-Executing and Broad Temporary Relief

The SEC Order considers 145 provisions of Dodd-Frank that amend the Securities Exchange Act of 1934 (the “**Exchange Act**”) and specifies which ones will go into effect on July 16.

The SEC interprets a significant number of these provisions – 53 in all – as not going into effect on July 16 because they depend on registration of persons, on publication of final rules or other SEC action that has not yet occurred. For example, the SEC determined that provisions that are intended to regulate SBS dealers will not be effective on July 16, on the basis that such provisions explicitly (or implicitly) apply only to “registered” persons. Such provisions include, among others, those that would have required, beginning on July 16, SBS dealers to designate a chief compliance officer and comply with heightened standards of care when advising special entities, such as municipalities and pension funds. There is a separate category of provisions that will go into effect on July 16 but will not require compliance on that date because such provisions authorize or direct the SEC to take action. Such provisions include, for example, the provision that authorizes the SEC to adopt rules applicable to SBS dealers.

There are 18 provisions that will be effective and require compliance beginning on July 16. These provisions include, among others:

- beneficial ownership provisions, for which the SEC has adopted a final rule;¹
- the requirement for institutional investment managers to report their purchases and sales of SBS;
- the prohibition on holding customer margin for cleared SBS absent registration as an SBS dealer, broker or dealer (which, as of July 16, only will affect SBS that are voluntarily cleared since SBS will not be required to be cleared until the SEC designates SBS for mandatory clearing);
- the requirement to execute on a securities exchange SBS entered into with any person that was not an eligible contract participant as of July 15; and
- the requirement to segregate initial margin delivered by counterparties for cleared SBS.

The SEC noted that it will consider individual requests (in some cases by clearing agencies on behalf of individual participants) for relief from certain of these provisions.

The SEC further provides full or partial temporary relief for the most significant provisions that would otherwise have affected the market on July 16. The SEC Order specifies that the relief will expire upon the adoption of related final rules and the compliance dates specified in related final rules. The SEC temporarily exempts persons that are eligible contract participants under the pre-Dodd-Frank definition from the requirement to execute their SBS on a national securities exchange until the effective date for the final rules defining the term “eligible contract participant.” The SEC Order also exempts SBS dealers and major SBS participants from restrictions on association with persons subject to a statutory disqualification. SBS dealers and major SBS participants are also temporarily exempt from the collateral segregation requirements for uncleared SBS until the registration rules are effective.

Market participants are also temporarily exempted from the statutory requirement to report pre-enactment SBS by January 12, 2012. Instead, the SEC will require such SBS to be reported on the same schedule as was proposed in the SEC’s reporting rule, that is, six months after the date that an SBS data repository that is capable of accepting the asset class of such SBS registers with the SEC.

¹ SEC Final Rule on Beneficial Ownership Reporting Requirements and Security-Based Swaps, 76 Fed. Reg. 34,579 (June 14, 2011).

Markets that trade SBS are also granted temporary exemptive relief from the requirement to register as a national securities exchange or an SBS execution facility. Such relief will last until the earliest compliance date set forth in the final rules regarding registration of SBS execution facilities.

Effect of Security-Based Swaps Becoming Securities on July 16

Two important provisions that have created great uncertainty in the markets are those that will redefine the term “security” under the Exchange Act and the Securities Act of 1933 (the “**Securities Act**”) to include SBS. The SEC Order emphasizes that this definitional change will go into effect on July 16. As interpreted by the SEC, the existing antifraud provisions will apply to SBS from July 16.

The SEC stated that it will separately provide relief from certain existing Exchange Act provisions, other than the antifraud and antimanipulation provisions.

Absent relief, any person that acts as an agent for SBS transactions would be required to register with the SEC as a broker-dealer and comply with broker-dealer requirements regarding SBS.

The SEC proposed exemptions under the Securities Act, the Exchange Act and the Trust Indenture Act on June 10 for SBS issued by certain clearing agencies satisfying certain conditions.² Since exemptive relief under the Securities Act must be done through rulemaking and be subject to public comment, it is unclear whether the SEC will provide further guidance or relief on the application of the Securities Act prior to July 16.

Legal Certainty for SBS Contracts

Prior to the SEC Order, market participants were worried that section 29(b) of the Exchange Act could raise concerns about the enforceability of SBS transactions if there were an inadvertent violation of Exchange Act requirements that become applicable to SBS entered into after July 16. Section 29(b) provides that contracts made in violation of the Exchange Act “shall be void as regards the rights of any person ... who made or engaged in the performance of any such contract.” The SEC Order, however, grants temporary relief to exempt any SBS entered into on or after July 16 from being void or considered voidable by section 29(b) because of a provision of Dodd-Frank that is not effective on July 16. This temporary exemption will terminate as the provisions amending the Exchange Act come into effect. Such contracts could, however, be void or voidable as a result of violations of the antifraud provisions of the Exchange Act.

Secondary Impact of Security-Based Swaps Becoming Securities on July 16

The change in the definition of “security” in the Securities Act or Exchange Act to include security-based swaps may have secondary effects on other federal, state and local laws, self-regulatory organization rules and corporate governance documents, investment guidelines and other documents that incorporate by reference the definition of security that is used in the Securities Act or Exchange Act. For example, absent relief from FINRA, SBS transactions conducted in registered broker-dealers will be subject to FINRA margin requirements, best execution rules, Know Your Customer requirements and other account opening requirements.

² SEC Proposed Rule on Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies, 76 Fed. Reg. 34,920 (June 15, 2011).

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