Swap Reporting Clearing & Trading: A Timing Guide

By Annette Nazareth and Gabriel Rosenberg

In the November 2011 issue of *Futures Industry*, we discussed the significant uncertainty around the timing of Dodd-Frank swap market reforms and the problems that this uncertainty raised for swap market participants. Seven months later, the timeline is gradually becoming clearer.

The CFTC has finalized several Dodd-Frank rules and has released a proposed timetable for finalizing the rest. In this article, we provide an update on how the CFTC's proposed and final rules, along with Commissioner Scott O'Malia's draft rule schedule, create a preliminary schedule of swap reporting, clearing and trading requirements for swap market participants.

Reporting

To enhance regulators' visibility into the swap markets, Dodd-Frank mandates that swap information be reported to swap data repositories. To promote public transparency, a subset of this reported information, including swap price and size, must be disseminated to the public in real-time.

The CFTC finalized its swap reporting rules on December 20, 2011. These rules, following the statute, place the primary reporting burden on CFTC-registered swap dealers and major swap participants or any swap execution facility or designated contract market on which the swap is traded.

CFTC Proposed Timing of Key Reporting, Clearing and Trading Rules

June and July 2012

- Swap Product Definitions
- Clearing End-User Exemption
- Clearing Phase-In
- Mandatory Clearing Determination Proposal
- SEF Core Principles
- DCM/SEF "Made Available to Trade" Determinations
- Mandatory Trading Phase-In

Fall 2012

- Block Trades
- DCM/SEF/DCO Conflicts of Interest and Governance
- Margin Requirements for Non-Banks

When neither party to a swap is a swap dealer or major swap participant, then one of the parties will need to report the trade.

The CFTC's rules phase in reporting requirements by type of market participant and type of swap. SDs and MSPs will need to start reporting credit and interest rate swap transactions as of the day that they are required to register with the CFTC. We expect this registration date to be in the third quarter of 2012. Ninety days later—likely in the fourth quarter of 2012—swap dealers and MSPs will need to start reporting all other swaps. Ninety days after that—likely in the first quarter of 2013—other market participants will need to report to SDRs swaps they enter into with non-SD/MSP counterparties.

Between now and the required reporting dates, market participants will need to establish connections to SDRs and the operational and technological capability to collect swap information and report it. Many SDs and MSPs, for whom these requirements will become effective first, have already started the process. By 2013, end users—including those that function as dealers in particular markets but fall below the SD de minimis thresholds—will need to identify swaps they enter into with non-SDs/MSPs and ensure they have arrangements or systems in place to report those swaps.

Clearing

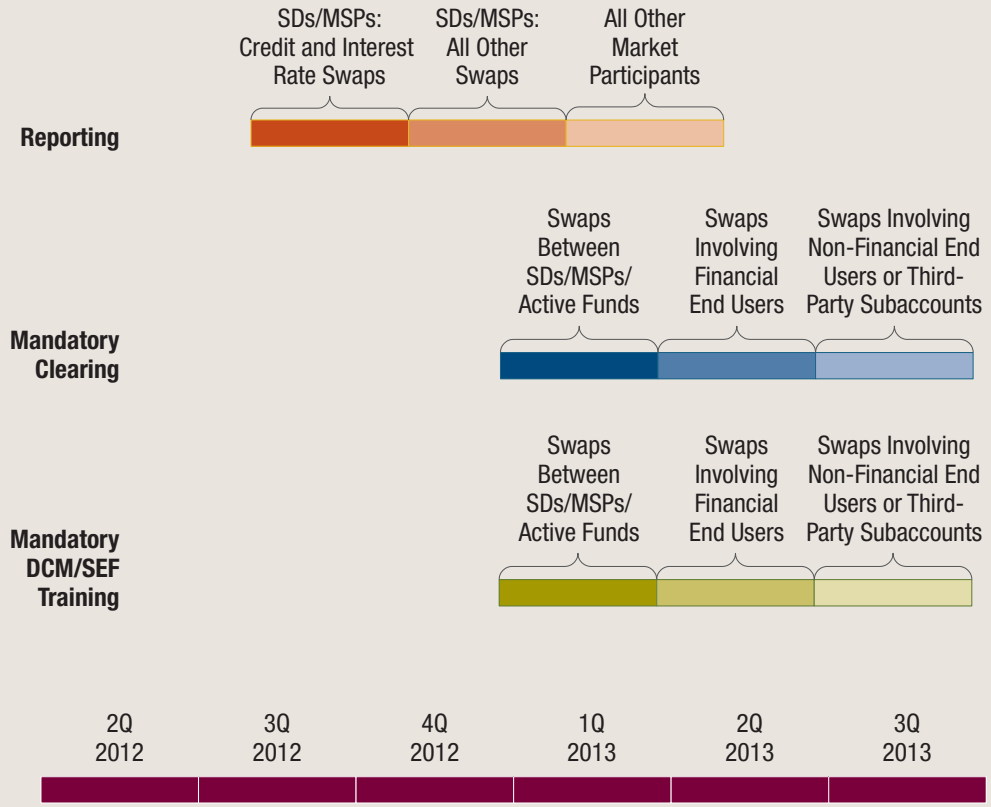
To decrease counterparty credit risk in the swap markets, Dodd-Frank requires central clearing for swaps. The central counterparty will collect initial and variation margin from swap counterparties and ensure its own financial stability through guaranty funds and risk management procedures. Commercial end users will be eligible for an exemption from the clearing requirements for any swap entered into to hedge or mitigate commercial risk, subject to meeting a number of obligations around making that election.

The CFTC's proposed rule schedule suggests that in June the agency will begin proposing specific swaps that must be cleared. Consistent with Dodd-Frank, the schedule indicates that the CFTC will review the proposal and related public comments for 90 days. As a result, we expect the first mandatory clearing requirements to be finalized in September or October. The first swaps that are required to be cleared are expected to be liquid interest rate and index credit default swaps.

In September 2011, the CFTC proposed a rule that would phase in compliance with mandatory clearing determinations by three tiers of market participants. This rule, which is scheduled to be finalized in June, would require clearing of a swap between two entities that are SDs, MSPs or "active funds" within 90 days of a CFTC determination that the swap has to be cleared. If the rule is finalized as proposed, we would expect these first swap clearing requirements to become effective in the first quarter of 2013. Financial end users, other than third-party managed subaccounts, would have 180 days to comply, while commercial end users and third-party managed subaccounts would have 270 days. This would place the first clearing requirements for these groups in the second and third quarter of 2013, respectively.

In advance of clearing compliance, market participants will need to ensure they have access to a clearinghouse. For all but the biggest market participants, this will

Estimated Reporting, Clearing and Trading Deadline



require developing a relationship with one or more clearinghouse members, each of which will need to be a registered futures commission merchant. Commercial end users will need to consider whether or not to avail themselves of the commercial end user exception from the clearing requirement and, if so, will need to obtain board approval and meet other CFTC requirements before clearing requirements are phased in.

DCM/SEF Trading

To promote pre-trade price transparency, Dodd-Frank requires that all cleared swaps must be executed on a DCM or SEF, unless no DCM or SEF makes the swap "available for trading." The CFTC has proposed rules governing SEFs and the "available for trading" determination. Both are scheduled to be finalized in July.

The CFTC's September 2011 phase-in proposal would link the timing of mandatory DCM or SEF trading to the timing of the clearing requirements. Market participants would not be required to trade a swap on a DCM or SEF until the date they are required to clear the swap or 30 days after the swap is "made available for trading," whichever comes later. As a result, DCM and SEF trading is unlikely to begin before the first or second quarter of 2013 for trades between SDs, MSPs and active funds; the second or third quarter of 2013 for trades involving financial end users; and the third or fourth quarter of 2014 for trades involving commercial end users and third-party subaccounts.

In advance of these compliance dates, market participants will need to ensure they have access to SEFs or DCMs, either directly or through a market intermediary. Market participants will also need to monitor which swaps are "made available to trade" and choose whether to use these standardized swaps or, instead, opt for more customized bilateral swaps that do not need to be traded on SEFs or DCMs but may be subject to higher margin and capital requirements.

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Cross-Border Impact of Title VII

Looming large in the background of any discussion of Title VII timing and preparedness is the question of the cross-border reach of Dodd-Frank's derivatives provisions. Section 722 of the statute provides that Title VII's provisions relating to swaps do not apply to "activities outside the United States" unless the activities in question: (1) "have a direct and significant connection with activities in, or effect on, commerce of the United States" or (2) are evasive. These vague criteria are not further defined, leaving market participants unsure as to how cross-border transactions will be treated, including for the reporting, clearing and trading requirements. For example, will a swap entered into between a New York branch of a non-U.S. bank and a non-U.S. counterparty need to be cleared at a CFTC-registered or recognized clearinghouse? What about a swap entered into between an offshore branch of a U.S. bank and a non-U.S. counterparty?

Market participants have needed to plan for Title VII compliance without answers to these questions. Slowly, details of the CFTC's likely approach have started to emerge. In a carefully crafted speech on May 21, Chairman Gensler outlined "key elements" of a possible CFTC cross-border approach. These include that:

- in determining whether a non-U.S. entity is a swap dealer, the CFTC will consider the entity's "U.S.-facing swap activity," a term which he did not define;
- transactions with overseas branches of persons or entities operating in the United States and transactions with overseas affiliates that are guaranteed by a U.S. entity or "operating as conduits for a U.S. entity's swap activity" will be considered "U.S.-facing transactions";
- Title VII swap requirements will be divided into "entity-level" (e.g., capital, risk management and recordkeeping) and "transaction-level" (e.g., clearing, margin, real-time public reporting, trade execution and sales practices);
- the CFTC may defer to comparable home-country regulation on entity-level requirements for overseas swap dealers; and
- transaction-level requirements will apply to all "U.S.-facing transactions," but may not apply to transactions between overseas swap dealer (including a foreign swap dealer that is an affiliate of a U.S. person) and non-U.S. counterparties not guaranteed by or operating as conduits for U.S. entities, such as a swap between a non-U.S. swap dealer and a non-U.S. insurance company that is not guaranteed by a U.S. person.

The CFTC's proposed rulemaking schedule lists two cross-border releases for June—proposed cross-border guidance and proposed cross-border relief. It is unclear exactly what these proposals will say or when exactly they will be released. Until then, market participants will be left planning for compliance with the reporting, clearing, trading and other elements of Dodd-Frank derivatives reform without a clear picture of the impact on their cross-border activities.—*Annette Nazareth and Gabriel Rosenberg*