

CFTC Proposes to Register and Regulate Swap Dealers and Major Swap Participants

Contents

Registration of Swaps

Entities	1
Swaps Entity Registration	1
Provisional Registration	2
Extraterritorial Application of Swaps Entity Registration Requirements	3

Duties of Swaps Entities

Conflict of Interest Policies and Procedures

Designation of a Chief Compliance Officer

On November 10, 2010, the CFTC proposed rules concerning swap dealers and major swap participants (“**swaps entities**”) under the Dodd-Frank Act. The rules address entity registration, conflicts of interest involving research and clearing activities, chief compliance officer designation and risk management, reporting and operational requirements.

While the proposed rules do not address other key topics, including margin, capital, documentation standards, reporting and sales practices, they provide considerable insight into the CFTC’s vision of how these newly regulated swaps entities will operate. In particular, the proposals impose very tight operational and compliance controls, buttressed by empowered chief compliance officers, independent risk management programs, periodic compliance certifications, tightly controlled new business processes, organizational barriers between certain sensitive functions, vigorous internal audit programs and a high degree of transparency to the CFTC and other regulators. While the proposed rules claim to afford swaps entities latitude to design policies and procedures that are appropriate to their own business profile, they will raise the costs of conducting the swaps business, expose swaps entities to enforcement actions for internal operational problems, and impose challenging organizational limitations.

Oddly, the proposals were released prior to the CFTC’s definitional rules (expected to be proposed by the CFTC on December 1) that will provide guidance on who will be considered a swap dealer and major swap participant. The registration rules also raise significant questions about the extraterritorial scope of the proposed requirements, leaving swap market participants uncertain regarding whether or how the proposed rules will apply to their swaps activities.

Comments are due on January 18, 2011 for the proposed chief compliance officer rule and, for the other rules, on January 24, 2011.

Registration of Swaps Entities

The CFTC’s proposed registration rule specifies the procedures through which swaps entities will register and the timing of the swaps entity registration requirements.

Swaps Entity Registration

The proposed registration rule would establish a registration regime for swaps entities similar to that for futures commission merchants (“**FCMs**”),

and require swaps entities to be a members of the National Futures Association (“NFA”).¹ While the CFTC’s further definition of “swap dealer” and “major swap participant” has yet to be released, the registration regime does not include exemptions for entities that transact only with affiliates.

To register as a swaps entity, and to apply for membership in the NFA, firms will file Form 7-R electronically with the NFA. Filing a Form 7-R authorizes the CFTC to conduct on-site inspections of the applicant. The applicant would also be required to file a Form 8-R on behalf of each of its principals along with a fingerprint card, which the NFA uses to conduct background checks and determine whether principals of applicants are subject to a statutory disqualification. Swaps entities would be required to review and update their NFA registration forms and any information provided to the CFTC annually.

Pursuant to Dodd-Frank, swaps entities are prohibited from associating with persons subject to a statutory disqualification, and the proposed registration rule would place the burden of compliance with this provision on the swaps entity. There is no provision for the CFTC or NFA to grant conditional or unconditional waivers of association with a statutorily disqualified person. Interestingly, the definition of “associated person of a swap dealer or major swap participant” is not limited to natural persons, which may have significant ramifications for organizations that are part of large corporate groups that may have affiliates subject to a statutory disqualification.

The proposed registration rule specifies a number of situations in which a swaps entity will face involuntary termination of its registration, including if compliance deficiencies are not cured within 30 days of receipt of a notice of deficiency. There does not appear to be due process or a gradation of possible sanctions that the CFTC can use in place of this severe remedy.

Provisional Registration

Due to the required timing of the issuance of various rulemakings under Dodd-Frank, the statute allows for the possibility that entities will be required to register as swap dealers or MSPs before it is clear which entities are required to so register and before the obligations of such entities are known. As a result, the CFTC’s proposed registration rule provides for “provisional registration” of swaps entities pending final CFTC rulemaking on the swaps entity definitions and conduct requirements.

The proposed registration rule would allow an entity, voluntarily, to register provisionally as a swaps entity beginning on April 15, 2011. Provisionally registered swaps entities would be required to comply with the requirements applicable to registered swaps entities as such provisions

¹ The proposed rule specifies that affiliates of insured depository institutions that are “swaps entities” under the Swaps Pushout Rule are subject to the registration requirement, but that “the Commission is not proposing any specific requirements at this time for any Push-Out Affiliate.” It is not clear why the CFTC felt the need to make this point or what requirements the CFTC might have in mind.

become effective. Swaps entities that have not provisionally registered by July 21, 2011 would be required to apply for registration by the effective date of the rules further defining the swaps entity terms and would be required to demonstrate their compliance with applicable conduct requirements effective as of the time of their application.

Under the proposed registration rule, provisional registrants that comply with all requirements would become fully registered upon the effectiveness of all swaps entity conduct requirements. Provisional registrants that cannot show compliance with effective requirements will be given 30 days to comply or withdraw their registration and cease activities requiring registration as a swaps entity, though the transactions entered into by that entity while provisionally registered, and prior to the notice of deficiency, will remain intact.

It is not clear what advantages accrue to a swaps entity that applies for provisional registration rather than waiting until the effective date of the definitions.

Extraterritorial Application of Swaps Entity Registration Requirements

Dodd-Frank provides that derivatives provisions of the statute that are administered by the CFTC will not apply to activities outside of the United States unless the activities “have a direct and significant connection with activities in, or effect on, commerce of the United States” or violate the CFTC’s anti-evasion rules. Since passage of Dodd-Frank, market participants have puzzled over the extent to which registration requirements will apply to non-U.S. entities as swaps entities. The proposed registration rule provides one of the first indications of the CFTC’s inclination on extraterritorial impact of Dodd-Frank.

In the proposing release, the CFTC states that it will not require registration of persons whose activities have “no connection or effect of any kind, direct or indirect, whether through affiliates or otherwise, to U.S. commerce” and further notes that “considerations of international comity” play a role in the scope of extraterritorial application of federal statutes. The CFTC states that it generally would not require registration of an entity as a swap dealer due solely to use of a U.S.-registered swap execution facility, designated clearing organization, designated contract market or swap data repository. At the other extreme, the CFTC indicates that a person who “engages in swap dealing activities and regularly enters into swaps with U.S. persons” would likely be required to register as a swap dealer.

The release raises great concern by asking for comment on when swap dealing activity *with or by* non-U.S. affiliates of U.S. persons has a direct and significant connection with or effect on US. commerce. It asks specifically about the impact on the United States of swap dealers outside the U.S. that deal with foreign affiliates of U.S. persons.

The CFTC further notes that the extraterritorial reach calculation is different for major swap participants than for swap dealers and will focus on the positions that the entity has with U.S. counterparties.

Risk Management System

Swaps entities' risk management programs must, among other requirements:

- create a "risk management unit" that reports directly to senior management and is independent of the business trading unit;
- require the risk management unit to create detailed quarterly "risk exposure reports";
- require reporting of any material change in the risk exposure of the swaps entity;
- require quarterly review by senior management and annual review by the governing body of risk tolerance limits;
- include a "new product policy" with specific content;
- establish policies and procedures relating to central counterparties that encourage the use of central counterparties to mitigate counterparty credit risk and require investigation into the adequacy of the financial resources and risk management procedures of used central counterparties; and
- ensure that capital and margin requirements are met.

Oversight of Swaps Entities

The proposed registration rule asks for comment on three options for oversight of swaps entities. Under the first option, the CFTC would be responsible for oversight of swaps entities and their compliance with regulatory requirements. Under the second option, the NFA or any other futures association that comes into existence would be responsible for oversight of swaps entities, subject to supervision by the CFTC. Under the third option, the CFTC would share oversight responsibility with the NFA or other futures associations that come into existence.

Duties of Swaps Entities

The CFTC proposed six rules under Dodd-Frank to specify swaps entity duties to:

- monitor trading to prevent violations of applicable position limits;
- establish robust risk management systems for managing the day-to-day business of the swaps entity;
- disclose to the CFTC and prudential regulator information concerning terms and conditions of its swaps, swap trading operations, mechanisms and practices, financial integrity protections relating to swaps and other information relevant to its trading in swaps;
- establish and enforce internal systems and procedures; and
- prohibit anticompetitive activity.

The proposals would require swaps entities to create a risk management program that includes written policies and procedures described in the accompanying sidebar. The duties appear to apply to the business and clearing activities of the swaps entities involving all products, not just swaps, which would sweep in the full activities of a bank, broker-dealer or FCM that registers as a swaps dealer. The risk management program must be approved by the governing body of the swaps entity, be provided to the CFTC at the time of registration and be updated when material changes are made. The proposal would require that the risk management program consider not only the risks of the swaps entity, but also those posed by the swaps entity's affiliates. In particular, the proposed rule would require the risk management program to "take an integrated approach to risk management at the consolidated entity level."

As part of the risk management program, swaps entities will be required to create a "risk management unit" that must report directly to senior management and be independent of the swaps entity's business trading unit. It is unclear how this risk management unit will be organized in large, multi-service entities in which swap activity is only a part of the entity's business, or in those entities where U.S.-based swap activity is conducted in a stand-alone swap dealer but risk management is handled at a parent or holding company-level by persons who report to senior management of the parent company but not to senior management of the U.S. swap dealer.

Oversight of Trading Activities

As part of oversight of trading activities, the risk management program must:

- provide for approval of all trading policies by the governing body of the swaps entity;
- permit traders to execute transactions only when a credit limit has been established for a given counterparty;
- include limits on the ability to commit the capital of the swaps entity;
- monitor traders to prevent them from exceeding limits;
- require traders to follow established policies and procedures for executing and confirming transactions;
- detect unauthorized trading activities and violations of policies and procedures;
- ensure that trade discrepancies are brought to the immediate attention of management of the business trading unit and documented;
- ensure the risk management unit reviews and monitors brokers;
- subject algorithmic trading programs to policies and procedures governing use, supervision, maintenance, testing and inspection of the programs; and
- separate the personnel in the business trading unit from personnel in the risk management unit.

The proposed rules require significant ongoing board-level approvals related to the risk management program, including for the program's risk limits and "new product policy." It is unclear how this ongoing requirement will be met in a large multi-service entity where risks constantly change and whether some delegation of the board-level approval is possible. In addition, testing of the risk management program is required at least quarterly and whenever there is a material change in the business of the swaps entity that is likely to alter its risk profile. Such assessments must be done by either qualified internal audit staff that are independent of the business trading unit or by a qualified third-party audit service, and they must be reported to and reviewed by key personnel of the swaps entity. Reviews and testing must be documented fully and provided to the CFTC upon request.

Under the proposed rules, swaps entities would be required to establish policies and procedures relating to central counterparties, including policies and procedures that "set forth the conditions for the use of central counterparties for clearing when available as a means of mitigating counterparty credit risk." This would appear to create pressure to clear swaps even when not explicitly required by the CFTC. The central counterparty policies and procedures must also include a review of the adequacy of the financial resources and risk management procedures of central counterparties used by the swaps entity.

The risk management system must oversee the trading activities of the swaps entity. The key elements of this oversight can be found in the accompanying sidebar. As part of this oversight of trading activities, swaps entities must subject algorithmic trading programs to policies and procedures governing use, supervision, maintenance, testing and inspection of programs. This requirement is not limited to proprietary systems within the swaps entity's control, and so third-party software used as part of algorithmic trading may be subject to the swaps entities' policies and procedures.

Swaps entities would be required to adopt policies and procedures for compliance with position limits set by the CFTC, designated contract markets and swap execution facilities. The swaps entity would be required to implement a position limit early warning system, test the effectiveness of the position limit policies and procedures and report quarterly to the chief compliance officer, senior management and governing body of the swaps entity regarding compliance with the position limit policies and procedures. These policies and procedures must be audited annually, and significant recordkeeping requirements apply.

In addition, swaps entities would be required to establish and maintain written business continuity and disaster recovery plans designed to enable the swaps entity to resume operations the business day after a disruption with minimal disturbance to counterparties and to recover all required documentation and data. Back-up facilities and personnel would be required.

The CFTC asks for public comment on whether "staggered or delayed effective dates for some regulations based on the nature or characteristics of the activities or entities to which they apply" would be appropriate.

Research Report

“Research report” is defined as: any written communication (including electronic) that includes an analysis of the price or market for any derivative, and that provides information reasonably sufficient upon which to base a decision to enter into a derivatives transaction, but does not include:

- communications distributed to fewer than 15 persons;
- periodic investment performance reports or other communications prepared for investment company shareholders or commodity pool participants;
- any communication generated by an employee of the business trading unit that is conveyed as a solicitation for entering into a derivatives transaction, and is conspicuously identified as such; and
- internal communications that are not given to current or prospective customers.²

Conflict of Interest Policies and Procedures

Dodd-Frank requires swaps entities to create systems to ensure that activities involving research or analysis of the price or market for any commodity or swap are separated from the review, pressure or oversight of persons whose involvement in pricing, trading or clearing activities could bias judgments or supervision. In addition, swaps entities are required to create systems to ensure that clearing activities and the determination of whether to accept clearing customers are separated from the review, pressure or oversight of persons whose involvement in pricing, trading or clearing activities could bias judgments or supervision. In both cases, the systems must ensure that such conflicts of interest do not lead to violation of Dodd-Frank’s open access requirements or business conduct standards. The CFTC’s proposed rule on swaps entities’ conflict of interest policies and procedures would implement these requirements.³

The research proposal, based largely on FINRA’s equity research rule, would:

- prohibit “non-research personnel” -- employees of the swaps entity not directly responsible for or otherwise involved with research concerning a derivative (other than legal or compliance personnel) -- from influencing the content of a research report (defined in the accompanying sidebar) of the swaps entity;
- prohibit research analysts -- employees of a swaps entity primarily responsible for preparation of the substance of a research report relating to a derivative and employees who report to such a person -- from being subject to supervision or control of employees of the swaps entity’s business trading unit or clearing unit;
- prohibit personnel engaged in pricing, trading or clearing activities from having influence or control over evaluation or compensation of research analysts;
- prohibit non-research personnel, other than the swaps entity’s board of directors and committees, from reviewing or approving a research report of the swaps entity before publication other than to review for conflicts of interest and for errors (subject to certain controls);

² This definition of research report does not appear to exempt reports primarily about a non-derivative security, issuer or general economic or industry conditions in which discussion of swaps is incidental.

³ The proposed rule defines a swaps entity’s “business trading unit” to include any department, division, group or personnel of the swaps entity *or any of its affiliates* performing pricing, trading, sales, marketing, advertising, solicitation, structuring or brokerage activities on behalf of the swaps entity in order to implement the research conflict of interest provision. Likewise, the proposed rule defines a swaps entity’s “clearing unit” to consist of any department, division, group or personnel of the swaps entity *or any of its affiliates* with respect to clearing-related conflicts performed or involved in any proprietary or customer clearing activities on behalf of a swaps entity in order to implement the clearing conflict of interest provision.

- require that all communications from research analysts to current or potential counterparties relating to derivatives not omit material facts;
- prohibit swaps entities from considering a research analyst's contribution to trading or clearing business in determining compensation;
- prohibit swaps entities from promising favorable research or threatening unfavorable research to induce business or compensation;
- require, in a prominent way and with records to demonstrate compliance, swaps entities to disclose in research reports, and a research analyst to disclose in public appearances, financial interests in derivatives that the analyst follows and other material conflicts of interest known by the research analyst;
- require independent third-party research reports that are not provided by request of the customer or through a website maintained by the swaps entity to disclose conflicts; and
- prohibit retaliation against research analysts.

The CFTC's clearing conflicts of interest proposal would:

- prohibit swaps entities from interfering with an affiliated clearing member's determinations to provide clearing services to customers, submit a transaction to a particular clearinghouse, set risk tolerance levels for particular customers, accept forms of collateral from particular customers and set clearing fees;
- require swaps entities to create and maintain informational partitions between business trading units of the swaps entity and clearing member personnel of any affiliated clearing member, which must require that no employee of a business trading unit of a swaps entity supervise, control or influence employees of the clearing member; and
- require swaps entities to adopt and implement written policies and procedures mandating disclosure to counterparties of material incentives and material conflicts of interest regarding the decision whether to execute a swap on a swap execution facility or designated contract market and whether to clear the swap.

The proposed conflict of interest rules demonstrate the CFTC's intention to strictly regulate the behavior of employees of swaps entities and their affiliates, even though such controls may be burdensome, costly and potentially beyond the scope of what is required under Dodd-Frank.

The proposal evidences the CFTC's fear that internal pressures at swaps entities will translate into unequal access to clearing facilities for customers. However, as a practical matter, these proposed rules will prevent swaps entity personnel with knowledge of and background in swaps and swap clearing from being involved in clearing credit or risk management analysis.

CCO Annual Report

The CCO's annual report must:

- contain a description of the swaps entity's compliance with compliance policies;
- identify the policies and procedures that ensure compliance with each Dodd-Frank provision and CFTC regulation, assess the effectiveness of those policies and procedures, discuss areas for improvement and make appropriate recommendations;
- certify the swaps entity's compliance with Section 619 (the "**Volcker Rule**") and Section 716 (the "**Swaps Pushout Rule**") of Dodd-Frank;
- list material changes to compliance policies since the last annual report;
- describe financial, managerial, operational and staffing resources for compliance and any deficiencies in those resources;
- describe instances of non-compliance with policies and procedures and the remedies taken; and
- discuss the roles and responsibilities of the board of directors and senior officer, relevant board committees and staff in addressing conflicts of interest, including coordination with or notification of other regulators.

Designation of a Chief Compliance Officer

The CFTC's proposal requires swaps entities and FCMs to designate a chief compliance officer ("**CCO**") who would report to the board of directors or senior officer of the swaps entity or FCM. The CCO would be required to meet with the board of directors or senior officer at least once a year regarding the swaps entity's compliance program. Though the CCO would not be required to register as a principal, the CCO would otherwise be considered a "principal" of the swaps entity or FCM and may not be subject to a statutory disqualification.

The CCO would be responsible for:

- establishing compliance policies in consultation with the board of directors or senior officer;
- resolving any conflict of interests in consultation with the board of directors or senior officer;
- reviewing and ensuring compliance with policies, laws, rules and regulations;
- establishing procedures to respond to noncompliance, in consultation with the board of directors or senior officer; and
- preparing, signing and certifying an annual report, described in more detail in the accompanying sidebar.

The CCO would be required to provide its annual report to the board or senior office for their review. In addition, the CCO would submit the report electronically to the CFTC within 90 days of the end of the swaps entity's fiscal year, though the swaps entity may apply to the CFTC for an extension. The CCO must certify that, to the CCO's best knowledge and reasonable belief, the information in the annual report is accurate and complete, and must provide amended reports if material errors or omissions are found, though it is unclear how broadly the obligation extends. The swaps entity would further be required to maintain copies of compliance policies and procedures, documents related to review of the annual report and records relevant to the annual report, which must all be made available to the CFTC and prudential regulators upon request.

The CCO's responsibilities are broadly stated, and it is unclear whether the CFTC will provide further guidance on how the CCO can satisfy the mandate of "ensuring compliance with policies, laws, rules and regulations." In addition, it is not clear to what extent the CCO can delegate required work or rely upon the work of others.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Daniel N. Budofsky
212 450 4907
daniel.budofsky@davispolk.com

Robert L.D. Colby
202 962 7121
robert.colby@davispolk.com

Annette L. Nazareth
202 962 7075
annette.nazareth@davispolk.com

Lanny A. Schwartz
212 450 4174
lanny.schwartz@davispolk.com

Gabriel D. Rosenberg
212 450 4537
gabriel.rosenberg@davispolk.com

References

[CFTC Proposed Rule on Registration of Swap Dealers and Major Swap Participants](#)

[CFTC Proposed Rule on Duties of Swap Dealers and Major Swap Participants](#)

[CFTC Proposed Rule on Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants](#)

[CFTC Proposed Rule on Designation of a Chief Compliance Officer and Preparation of an Annual Compliance Report for Swap Dealers, Major Swap Participants and Futures Commission Merchants](#)

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