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**Dodd-Frank Title VII Update:
Where Are We and Where Are We Going?
10 Important Issues Facing
Derivatives Users**

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- **Where We Are Today**
 - Dodd-Frank Act passed July 21, 2010
 - 42 CFTC Proposed Rulemakings and 1 Interpretive Order
 - Not Including Advanced Notices of Proposed Rulemakings or Interim Final Rules
 - 10 Open Comment Periods
 - 3 Proposed Rules and 1 Interpretive Order have not yet been published in the Federal Register
- **Where We're Going**
 - Several key rulemakings are pending, including:
 - Definition of a Swap
 - Capital and Margin Requirements
 - Next CFTC Open Meeting is expected to be at the end of March 2011
- **All Rules to be in Place by July 2011 (but effective dates will vary)**

Key Items With Open Comment Periods

- Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants
 - Comments due February 28, 2011
- Position Limits
 - Comments due March 28, 2011
- Additional Documentation Requirements for Swap Dealers and Major Swap Participants
 - Comments due April 11, 2011
- Commodity Options and Agricultural Swaps
 - Comments due April 4, 2011
- CPO and CTA Compliance Obligations
 - Comments due April 12, 2011

10 Important Issues Facing Derivatives Users

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1. Margin Requirements – Cleared and Uncleared
2. Mandatory Clearing Requirements
3. Swap Entity Definitions (Swap Dealer and Major Swap Participant)
4. External Business Conduct Rules
5. Swap Recordkeeping and Reporting Requirements
6. Legal Documentation for Cleared and Uncleared Trades
7. Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements
8. Regulation of Commodity Options and Agricultural Swaps
9. Position Limits
10. Uncertainty

1 Margin Requirements

- **Capital and Margin Requirements for Cleared Swaps**
 - Capital set by “Prudential Regulators,” CFTC and SEC (rules not yet proposed)
 - Margin set by derivatives clearing organizations
- **Capital and Margin Requirements for Uncleared Swaps**
 - Capital set by Prudential Regulators, CFTC and SEC
 - Margin set by swap dealers and major swap participants within guidelines set by CFTC and SEC
 - Not known whether end-users will be able to post non-cash collateral
 - Rules not yet proposed
- **End-User Exception to Mandatory Margin Requirements for Uncleared Swaps**
 - Not in Dodd-Frank Act
 - CFTC considering
 - Unknown whether exception would also be available to certain financial institutions

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Margin Requirements (cont'd)

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- Segregation of Margin for Cleared Swaps
 - CFTC Advance Notice of Proposed Rulemaking issued on November 19, 2010
 - Risk to customers in existing futures model
- Segregation of Initial Margin for Uncleared Swaps
 - CFTC Proposed Rule Issued on November 19, 2010
 - Market participants may require their swap dealer or major swap participant counterparties to segregate initial margin posted to the swap dealer/major swap participant

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Mandatory Clearing Requirements

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- CFTC regulations, to date, have not addressed this issue in a way that clearly puts market participants on notice as to what swaps will be eligible for clearing
- Process for Review of Swaps for Mandatory Clearing
 - CFTC Proposed Rule issued on October 26, 2010
 - Derivatives clearing organizations and, in some cases, CFTC and SEC will determine which swaps will be cleared
- End-User Exception from Mandatory Clearing
 - CFTC Proposed Rule issued on December 9, 2010
 - Transactions that hedge or mitigate commercial risk
 - May be available to certain financial institutions
- Venues for Cleared Swaps
 - Designated Contract Markets (i.e., regulated exchanges)
 - Swap Execution Facilities

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Swap Entity Definitions

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- CFTC Proposed Rule issued on December 1, 2010
- Swap Dealers
 - Entities that seek to accommodate the trading interests of other parties
 - Narrow safe-harbors
- Major Swap Participants
 - Substantial position
 - Potential exposure and potential future exposure
 - “Out-of-the-money” to dealers
 - High dollar thresholds
 - \$1 Billion – Potential Exposure (excludes collateralized exposure)
 - \$3 Billion – Potential Exposure (excludes collateralized exposure) plus Potential Future Exposure (substantial “haircut” for positions that are either cleared or subject to daily collateral transfers without thresholds)
 - Intended to capture a small number of market participants
- Consequences
 - Swap dealers and major swap participants subject to capital, margin, clearing, examination, reporting and business conduct rules

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External Business Conduct Rules

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- CFTC Proposed Rule issued on December 9, 2010
- Current Treatment
 - Counterparties in the current OTC derivatives market generally address business conduct concerns by incorporating non-reliance provisions into their swap documentation that clarify the relationship between the parties
- Proposed Business Conduct Standards
 - Verification of eligible contract participant status
 - Disclosure requirements
 - Daily Marks
- SIFMA and ISDA Comment Letter – Non-Reliance Revisited
 - Trade by trade vs. overall relationship

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Swap Recordkeeping and Reporting Requirements

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- CFTC Proposed Rules issued on November 19, 2010
 - Two rules with respect to reporting swap transaction data that will apply to all swap market participants, regardless of whether they are swap dealers or major swap participants
 - Swap Data Recordkeeping and Reporting Requirements
 - Real-Time Reporting
- End users that are not swap dealers or major swap participants will generally not be subject to reporting requirements
 - For cleared swaps that are executed on a designated contract market (DCM) or swap execution facility (SEF), the DCM/SEF and the derivatives clearing organization will have the majority of the reporting obligations.
 - Major swap participants and swap dealers will also have reporting requirements, which will vary based on the type of swap, whether it is executed on a DCM or SEF and whether it is cleared

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Swap Recordkeeping and Reporting Requirements (cont'd)

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- End users will be subject to recordkeeping requirements
 - End users must maintain “full, complete and systemic records” with respect to each swap to which they are a counterparty
 - Records must be kept throughout the life of the swap and for five years after final termination of the swap
 - Records must be retrievable within three business days
- Recordkeeping requirements for swap dealers and major swap participants are more comprehensive
 - Must maintain daily trading records sufficient to conduct a comprehensive and accurate trade reconstruction (including pre-execution information and post-execution information)
- Interim rules applying to trades before Dodd-Frank Act and new regulations only require market participants to maintain existing data in its current form

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Legal Documentation for Clearing

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- Futures Account Agreements
 - Form, typically not negotiated
 - Vary from Futures Commission Merchant (FCM) to FCM
- Cleared Derivatives Transactions Addendum
 - FIA Working Group
- Cleared Derivatives Transactions Give-Up Agreement
 - FIA Working Group
- CFTC Proposed Rule issued on January 20, 2011
 - Requires swap dealers and major swap participants to create a record of each swap transaction that conforms to the template established by the rules of the applicable derivatives clearing organization

6 General Observations Regarding Legal Documentation for Clearing

OTC Non-Cleared Trades

- Collateral
 - Established by contract
 - Independent Amount limited
 - Delivery time fixed by contract
- Transfer/Assignment
 - Counterparty consent required
- Termination
 - Not authorized unless an event of default or other contractual termination event occurs

Cleared Trades

- Margin
 - Established by derivatives clearing organizations
 - No limitation on initial margin – additional margin may be required by FCM
 - Delivery on demand
- Transfer/Porting
 - Any time provided no event of default; Consent not required
- Termination
 - Permitted by either party upon written notice

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General Observations Regarding Legal Documentation for Clearing (cont'd)

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OTC Non-Cleared Trades

- Events of Default
 - Payment default-after notice and cure period
 - Other breaches-after notice and cure period
 - Typically no default for “insecurity” unless termination event is triggered (Note: We are aware of negotiated “Adequate Assurance” provisions.)

Cleared Trades

- Events of Default
 - Payment default-no notice or cure period
 - Other breaches-no notice or cure period
 - FCM may declare if it deems it necessary “for its protection”

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6 Legal Documentation for Uncleared Swaps

- CFTC Proposed Rule Issued on January 20, 2011
- Valuation Methodology and Dispute Resolution
 - Written documentation for uncleared swaps entered into by swap dealers and major swap participants must include methods, procedures, rules and inputs for valuing such swaps at all times during the life of the swaps
 - Valuation methodology must be independently verifiable
 - Valuation disputes must be reported to the CFTC
- Specific Documentation Requirements
 - Must include payment obligations, events of default, transfer rights, governing law, initial margin requirements, variation margin requirements and any custodial arrangements for collateral

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Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements

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- CFTC Proposed Rule issued on December 16, 2010
- Confirmation Requirements
 - Requires swap dealers and major swap participants to provide their counterparties with acknowledgments and/or confirmations for all trades within specified periods of time
- Portfolio Compression
 - Swap dealers and major swap participants to participate in multilateral portfolio compression exercises prescribed by the CFTC, a self-regulatory organization or a derivatives clearing organization
- Portfolio Reconciliation
 - Requires swap dealers and major swap participants to engage in portfolio reconciliation with respect to all of their uncleared swap transactions

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Regulation of Commodity Options and Agricultural Swaps

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- Dodd-Frank Act prohibits agricultural swaps absent a CFTC rule allowing them
- CFTC Proposed Rule issued on January 20, 2011
 - Allows agricultural swaps
 - Regulates agricultural swaps and commodity options like other swaps
 - Replaces existing eligible swap participant safe harbor for agricultural swap transactions with the eligible swap participant requirements applicable to all swaps that are not executed on an exchange

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Position Limits

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- CFTC is required to promulgate rules establishing position limits for futures and option contracts on commodities as well as swaps that are economically equivalent to such futures or options
 - Would apply to futures and option contracts on energy commodities, metals and agricultural commodities
- CFTC Proposed Rule Issued on January 13, 2011
 - Spot month position limits
 - Non-spot month position limits
 - Position visibility reporting
- Aggregation required if common ownership, common control or identical trading strategies

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Position Limits (cont'd)

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- **Initial position limits for spot month**
 - Limits currently imposed by the exchanges
 - Can have up to the position limit in physical contracts and up to the position limit in financially settled contracts
 - If a trader does not have any physical contracts, it can have up to five times the position limit in financially settled contracts
 - Could be effective as early as Spring of 2011 (after the comment period closes on March 28, 2011)
- **Additional position limits for non-spot months**
 - One level – positions can be in one month or spread out over multiple months
 - No separate limits for swaps and futures – can have all futures, all swaps or any combination thereof up to the position limit
 - Levels to be determined based on position visibility reporting
 - Would not take effect until March 2012 at the earliest

10 Uncertainty

- Definition of “Swap”
- Capital and Margin Requirements
- Final Forms of Proposed Rules
- Effective Dates

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Jamie Cain, a member of Sutherland's Corporate Practice Group, has extensive experience with public and private securities offerings by U.S. and foreign companies and with mergers and acquisitions of these companies. He is nationally known for his experience with respect to the use of over-the-counter (OTC) derivatives including interest rate, foreign exchange, equity and commodity transactions, and related collateral arrangements.

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