

## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Part 23

RIN 3038-AC96; 3038-AC97

#### Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements Under Section 4s of the CEA

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Further notice of proposed rulemaking.

**SUMMARY:** The Commodity Futures Trading Commission (Commission or CFTC) is proposing regulations that would establish a schedule to phase in compliance with previously proposed requirements, including the swap trading relationship documentation requirement under proposed 17 CFR 23.504, 76 FR 6715 (Feb. 8, 2011) and the margin requirements for uncleared swaps under proposed 17 CFR 23.150 through 23.158, 76 FR 23732 (Apr. 28, 2011). This release is a continuation of those rulemakings. The proposed schedules would provide relief in the form of additional time for compliance with these requirements. This relief is intended to facilitate the transition to the new regulatory regime established by the Dodd-Frank Act in an orderly manner that does not unduly disrupt markets and transactions. The Commission is requesting comment on the proposed compliance schedules, §§ 23.175 and 23.575, described in this release.

**DATES:** Submit comments on or before November 4, 2011.

**ADDRESSES:** For comments on proposed compliance schedule § 23.175, you may submit comments identified by RIN number 3038-AC96 and Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements under Section 4s of the Commodity Exchange Act (CEA). For comments on proposed compliance schedule § 23.575, you may submit comments identified by RIN number 3038-AC96 and Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements under Section 4s of the CEA. Comments may be submitted by any of the following methods:

- Agency Web site, via its Comments Online process at <http://comments.cftc.gov>. Follow the instructions for submitting comments through the Web site.

- *Mail:* David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

- *Hand Delivery/Courier:* Same as mail above.

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.

Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to <http://www.cftc.gov>. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that may be exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the established procedures in § 145.9 of the Commission's regulations, 17 CFR 145.9.

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from <http://www.cftc.gov> that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

#### FOR FURTHER INFORMATION CONTACT:

Mark D. Higgins, Counsel, Office of the General Counsel, 202-418-5864, [mhiggins@cftc.gov](mailto:mhiggins@cftc.gov); or Camden Nunery, Office of the Chief Economist, [cnunery@cftc.gov](mailto:cnunery@cftc.gov), 202-418-5723, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

#### SUPPLEMENTARY INFORMATION:

##### I. Background

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>1</sup> Title VII of the Dodd-Frank Act amends the CEA<sup>2</sup> to establish a comprehensive new regulatory framework for swaps. The legislation was enacted to reduce risk,

increase transparency, and promote market integrity within the financial system by, among other things: (1) Providing for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating robust recordkeeping and real-time reporting regimes; and (4) enhancing the rulemaking and enforcement authorities of the Commission with respect to, among others, all registered entities and intermediaries subject to the Commission's oversight.

To implement the Dodd-Frank Act, the Commission has to-date issued 55 advance notices of proposed rulemaking or notices of proposed rulemaking, two interim final rules, 12 final rules, and one proposed interpretive order. By the beginning of May 2011, the Commission had published in the **Federal Register** a significant number of notices of proposed rulemaking, which represented a substantially complete mosaic of the Commission's proposed regulatory framework under Title VII. In recognition of that fact and with the goal of giving market participants additional time to comment on the proposed new regulatory framework for swaps, either in part or as a whole, the Commission reopened or extended the comment period of many of its proposed rulemakings through June 3, 2011.<sup>3</sup> In total, the Commission has received over 20,000 comments in response to its Dodd-Frank Act rulemaking proposals.

To give the public an opportunity to comment further on implementation phasing, on May 2-3, 2011, the Commission, along with the Securities and Exchange Commission (SEC), held a joint, two-day roundtable on issues related to implementation.<sup>4</sup> In connection with this roundtable, Commission staff proposed thirteen concepts to be considered regarding implementation phasing, and staff asked a series of questions based on the concepts outlined.<sup>5</sup> The Commission has received numerous comments in

<sup>3</sup> See Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR 25274, May 4, 2011.

<sup>4</sup> The transcripts from the roundtable are available at [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/csjac\\_transcript050311.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/csjac_transcript050311.pdf) ("Day 1 Roundtable Tr.") and [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/csjac\\_transcript050211.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/csjac_transcript050211.pdf) ("Day 2 Roundtable Tr.").

<sup>5</sup> See "CFTC Staff Concepts and Questions Regarding Phased Implementation of Effective Dates for Final Dodd-Frank Rules," available at <http://cftc.gov/ucm/groups/public/@newsroom/documents/file/staffconcepts050211.pdf>.

<sup>1</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

<sup>2</sup> 7 U.S.C. 1 *et seq.*

response to both its roundtable and the staff concepts and questions.<sup>6</sup>

These comments have come from a variety of existing and potential market infrastructures, such as clearinghouses, trading platforms, and swap data repositories. Comments also have come from entities that may potentially be swap dealers (SDs) or major swap participants (MSPs), as well as those financial entities that may not be required to register with the Commission, but whose swap transactions may have to be conducted in compliance with certain requirements under Section 4s of the CEA by virtue of their trading with registered SDs or MSPs. For example, the swap transactions between SDs or MSPs and their counterparties will be subject to certain documentation of trading and margining requirements as proposed by the Commission in "Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants," 76 FR 6715 (Feb. 8, 2011),<sup>7</sup> (hereinafter "Trading Documentation") and "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," 76 FR 23732 (Apr. 28, 2011) (hereinafter "Margin Requirements").<sup>8</sup>

One of the key themes to emerge from the comments received by the Commission is that some market participants may require more time to ensure that their swap transactions comply with certain new regulatory requirements that will apply when they enter into swap transactions with registered SDs and MSPs.<sup>9</sup> For example, one commenter requested a "meaningful" period after finalization of the suite of rulemakings that is applicable to it before actual compliance will be required.<sup>10</sup> Similarly, several trade associations recommended the Commission allow "sufficient" time for infrastructure and business practices to develop before requiring compliance with the new requirements.<sup>11</sup> A group of international banks commented that the Commission should defer compliance

until December 31, 2012, at which point the regulatory timetable as per the September 2009 G20 Pittsburgh statement will have reached a conclusion.<sup>12</sup> Another commenter noted that some entities may be able to comply relatively quickly with certain documentation requirements that are largely consistent with current business practices while other requirements may need a longer implementation period.<sup>13</sup> Although commenters varied in their recommendations regarding the time it would take to bring their swaps into compliance with the new regulatory requirements, many commenters agreed on phasing in compliance with these requirements by type of market participant based on a variety of factors, including a market participant's experience, resources, and the size and complexity of its transactions.<sup>14</sup> The Commission has taken these comments into consideration in developing these proposed compliance schedules.

The swap transaction compliance requirements that are the focus of this proposed rulemaking include compliance with certain provisions of the Trading Documentation and Margin Requirements under Section 4s of the CEA.<sup>15</sup> The Commission's proposed compliance schedules are designed to afford affected market participants a reasonable amount of time to bring their transactions into compliance with such requirements. The proposed schedules also would provide relief in the form of additional time for compliance with these transaction compliance requirements and are further explained below. This relief is intended to facilitate the transition to the new regulatory regime established by the Dodd-Frank Act in an orderly manner that does not unduly disrupt markets and transactions.

Under this further notice of proposed rulemaking, the Commission is seeking additional public comment on proposed compliance schedules that ultimately would be included in final rules regarding Trading Documentation and Margin Requirements.<sup>16</sup> The proposed

schedules would be finalized and become effective at such time as the final Trading Documentation and Margin Requirement rules were published in the **Federal Register**.

## II. Proposed Regulation

### A. Authority To Implement Proposed Regulations

In this further notice of proposed rulemaking, the Commission relies on its general authority to phase in compliance with the rules and regulations enacted pursuant to the Dodd-Frank Act. Section 712(f) of Title VII also authorizes the Commission to promulgate rules to prepare for the effective dates of the provisions of the Dodd-Frank Act.<sup>17</sup> In addition, the Commission relies on Section 8(a)(5) of the CEA, which authorizes the Commission to promulgate such regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of the CEA. In accordance with this authority, the proposed regulations would amend part 23 of the Commission's regulations to phase compliance with previously proposed rules related to Trading Documentation and Margin Requirements under Section 4s of the CEA.

### B. Implementation Phasing of Trading Documentation Under Section 4s(i) of the CEA

#### 1. Background on the Trading Documentation Requirement

Section 731 of the Dodd-Frank Act added a new Section 4s(i)(2) to the CEA that requires the Commission to adopt rules governing documentation standards for SDs and MSPs. As described in Section 4s(i)(1), these documentation standards, as prescribed by the Commission, "relate to the timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps." On January 13, 2011, the Commission proposed regulations related to the Trading Documentation that SDs and MSPs must enter into with their counterparties in order to establish a swap trading relationship and document the swap transactions that occur pursuant to that relationship.<sup>18</sup>

<sup>17</sup> Section 712(f) of the Dodd-Frank Act states: "Beginning on the date of enactment of this Act and notwithstanding the effective date of any provision of this Act, the [Commission] \* \* \* may, in order to prepare for the effective dates of the provisions of this Act—(1) promulgate rules, regulations, or orders permitted or required by this Act \* \* \*."

<sup>18</sup> See Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715, Feb. 8, 2011.

<sup>6</sup> Such comments are available at <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1000>.

<sup>7</sup> CFTC Docket 3038–AC96.

<sup>8</sup> CFTC Docket 3038–AC97.

<sup>9</sup> E.g., Letter from Electric Trade Association, dated May 4, 2011 at 5; Letter from John R. Gidman, Association of Institutional Investors, dated June 10, 2011 at 3–4.

<sup>10</sup> Letter from the Coalition of Physical Energy Companies, dated Mar. 14, 2011 at 4.

<sup>11</sup> Letter from the Futures Industry Association, the Financial Services Forum, the International Swaps and Derivatives Association and the Securities Industry and Financial Markets Association, dated May 4, 2011 at 5.

<sup>12</sup> Letter from the Bank of Tokyo-Mitsubishi UFJ, Ltd., et al., dated May 6, 2011 at 6.

<sup>13</sup> Letter from the Financial Services Roundtable, dated May 12, 2011 at 4.

<sup>14</sup> These comments are more fully discussed later in the preamble.

<sup>15</sup> The Commission also is proposing Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA.

<sup>16</sup> This release should be considered to be a continuation of the rulemaking undertaken by CFTC Dockets 3038–AC96 and 3038–AC97. Only comments pertaining to the proposed compliance schedule will be considered as part of this Further Notice.

Specifically, previously proposed § 23.504(a) would require SDs and MSPs to establish, maintain, and enforce written policies and procedures designed to ensure that each SD or MSP and its counterparty agree in writing to all terms of their swap trading relationship and have executed all agreements required by the rules.<sup>19</sup> The proposal also would address the essential documentation needed to establish a trading relationship with a registered SD or MSP. Proposed § 23.504(b)(1) would require that the trading documentation include written agreement by the parties on terms relating to payment obligations, netting of payments, events of default or other termination events, netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures.<sup>20</sup> Proposed § 23.504(b)(2) would establish that all confirmations of swap transactions, as required under proposed § 23.501, would be considered to be part of the required swap trading relationship documents.<sup>21</sup>

Proposed § 23.504(b)(3) would require that the trading documentation include documentation of the credit support arrangements between the counterparties. These arrangements would include the counterparties' agreement on initial and variation margin requirements,<sup>22</sup> the types of assets that may be used as margin, and the investment and rehypothecation terms for those assets. The proposal also

would include the custodial arrangements for margin assets, including whether margin assets are to be segregated with an independent third party in accordance with Section 4s(l) of the CEA.<sup>23</sup>

Proposed § 23.504(b)(4) would require that a SD or MSP and its counterparty agree on how they will value each swap transaction into which they enter from the point of execution until the termination, maturity, or expiration of the swap.<sup>24</sup> Proposed § 23.504(b)(6) would establish certain documentation requirements for bilaterally-executed swaps that are subsequently submitted for clearing to a DCO. Finally, proposed § 23.504(b)(5), the subject of a separate notice of proposed rulemaking,<sup>25</sup> would require that a SD or MSP and its counterparty include in their Trading Documentation "a provision that confirms both parties' understanding of how the new orderly liquidation authority under the Title II of the Dodd-Frank Act and the Federal Deposit Insurance Act may affect their portfolios of uncleared, bilateral swaps."<sup>26</sup>

The audit, recordkeeping, and reporting provisions of proposed § 23.504(c), (d), and (e) that were proposed by the Commission at the same time as proposed § 23.504(a) and (b) would not be subject to the compliance schedule proposed below because the Commission believes that compliance with those requirements rests solely with registered SDs and

MSPs and would not require that SDs or MSPs work with their non-registrant counterparties to comply with these requirements.<sup>27</sup> The Commission solicits comment on whether the compliance schedule should be applied to these provisions as well. The Commission also solicits comment regarding whether the compliance schedule should be applied to proposed § 23.505, which relates to end-user exception documentation.

The Commission observes that before swap dealers and major swap participants could be required to comply with § 23.504, the Commission must adopt final rules related to confirmation of swap transactions<sup>28</sup> and the protection of collateral for uncleared swaps.<sup>29</sup> This is because the substance of the required documentation under proposed § 23.504 is found in those two rulemakings. For this reason, the Commission anticipates that it will finalize the confirmation and protection of collateral proposals at approximately the same time that it finalizes the Trading Documentation rule. Consequently, the compliance schedules proposed under this release would not become effective until the Commission finalizes those two proposals in addition to the Trading Documentation rule.<sup>30</sup>

In addition, the Commission recognizes that the swap transaction compliance schedules that are the subject of this proposal reference terms such as "swap," "swap dealer," and "major swap participant" that are the subject of rulemaking under sections 712(d)(1) and 721(c) of the Dodd-Frank

<sup>19</sup> 76 FR at 6725.

<sup>20</sup> 76 FR at 6726. In large part, proposed § 23.504(b)(1) reflects existing trading relationship documentation between counterparties, such as the widely-used ISDA Master Agreement, but does propose additional documentation requirements.

<sup>21</sup> 76 FR at 6717 and 6726. In particular, under proposed § 23.504(b)(2) parties must document the confirmation of their swap transactions. The Commission proposed the timing requirements for confirmation under § 23.501 in Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519, Dec. 28, 2010. However, the writing necessary for confirmation is required pursuant to § 23.504(b)(2) and was proposed under the Trading Documentation rules.

<sup>22</sup> See section ILC below for further discussion of Margin Requirements. Proposed § 23.504(b)(3)(i)–(iii) is intended to work together with, and serve as a cross-reference to, rules proposed by the Commission in its Margin Requirements proposal, § 23.151 (76 FR at 23744), as well as rules proposed by the prudential regulators related to initial and variation margin requirements for SDs and MSPs that are banks. See Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564, 27589, May 11, 2011 (proposing § .5 relating to documentation of margin matters). While proposed § 23.504 would apply to all SDs and MSPs registered with the Commission, the specific initial and variation margin requirements for SDs or MSPs would depend on whether the entity has a prudential regulator as that term is defined under Section 1a(39) of the CEA.

<sup>23</sup> As explained in the preamble to the Trading Documentation proposal, proposed § 23.504(b)(3)(iii) and (iv) are intended to work together with rules proposed under section 4s(l) of the CEA. 76 FR at 6718 (citing Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 75 FR 75432, Dec. 3, 2010). Accordingly, documentation of the collateral arrangements required under proposed § 23.601–603 would be included in the trading documentation required under § 23.504. Previously proposed § 23.601 requires that the SD and MSP notify each counterparty of the counterparty's right to elect for segregation of the collateral it supplies as initial margin. Previously proposed § 23.602 sets forth requirements for the treatment of segregated margin, including the use of an independent custodian and the requirement for a written agreement that includes the custodian as a party, and also allows for the SD or MSP to agree in writing with its counterparty that variation margin may also be held in a segregated account. Previously proposed § 23.603 relates to the investment and use of collateral.

<sup>24</sup> 76 FR at 6719. The valuation that would be established under § 23.504(b)(4) is relied upon in the Margin Requirements rule § 23.156(b)(1) as the basis for calculating variation margin. Similar valuation provisions also were included by the prudential regulators in their Margin and Capital Requirements proposal. See 76 FR 27589.

<sup>25</sup> Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants, 76 FR 6708, Feb. 8, 2011.

<sup>26</sup> 76 FR at 6709.

<sup>27</sup> While the compliance schedule proposed in this release would not apply to these provisions, the compliance dates for SDs and MSPs to come into compliance with these provisions will be taken up when the Commission adopts final rules.

<sup>28</sup> Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519, Dec. 28, 2010. The Commission notes that rules related to portfolio reconciliation (§ 23.502) and portfolio compression (§ 23.503) were not cross-referenced in the Trading Documentation rule and would not be required to be included in the counterparties' primary trading relationship documentation. However, if the Commission finalizes those requirements at the same time as the Trading Documentation rule parties may, in their discretion, include documentation establishing compliance with such provisions in their primary documentation, if applicable.

<sup>29</sup> Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 75 FR 75432, Dec. 3, 2010.

<sup>30</sup> In promulgating final rules regarding the timing of confirmation by SDs, MSPs, and their counterparties, the Commission will ensure that compliance with the final confirmation requirements work together with the compliance schedule as proposed under this release.

Act.<sup>31</sup> The Commission and the SEC have proposed rules that would further define each of these terms.<sup>32</sup> As such, and in a manner consistent with the temporary relief provided in the Commission's Effective Date Order,<sup>33</sup> the Commission must adopt final rules regarding the further definitions in question prior to requiring compliance with the Trading Documentation rule.

Lastly, the Commission must adopt final rules relating to the registration, including procedures for the provisional registration, of SDs and MSPs.<sup>34</sup> The finalization of these rules would enable SDs and MSPs to register with the Commission. As explained in the preamble to the proposed registration rule for SDs and MSPs, the Commission would afford SDs and MSPs an overall phased implementation approach with regard to the specific requirements under Section 4s (the "Section 4s Requirements").<sup>35</sup> In other words, SDs and MSPs would be able to provisionally register with the Commission and come into compliance with the Section 4s Requirements within the compliance deadlines set forth in the respective final implementing rulemakings.<sup>36</sup> The

specific compliance schedules proposed in this release comport with the approach discussed in the proposed registration rules.

Another proposed rule under Section 4s of the CEA indicated that certain requirements could be met through the use of swap trading relationship documentation (e.g., in the ISDA master agreement). The disclosure and documentation requirements proposed under the "Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties" rulemaking<sup>37</sup> could be included in Trading Documentation at the discretion of the SD or MSP and its counterparty. However, there is no express requirement under either the proposed Business Conduct Standards with Counterparties rules or proposed § 23.504 that the proposed disclosure and documentation requirements be included in the Trading Documentation. For that reason, issues related to compliance dates for the Business Conduct Standards with Counterparties rules will be taken up when finalizing that proposal.

## 2. Compliance Schedule for Documentation Requirements—§ 23.575

As stated above, the Commission is proposing a compliance schedule, § 23.575, that is specific to the documentation requirements of proposed § 23.504. Under the proposed compliance schedule in § 23.575, an SD or MSP would be afforded ninety (90), one hundred eighty (180), or two hundred and seventy (270) days to bring its Trading Documentation with its various counterparties into compliance with the requirements of proposed § 23.504, depending on the identity of each such counterparty. The categorization by type of counterparty is discussed further below.

As a practical matter, in order for SDs and MSPs to comply with the requirements of proposed § 23.504, they will need to work with each of their counterparties, including non-registrants, to review, negotiate, execute, and deliver the documentation required by proposed § 23.504. Because every bilateral swap transaction has two counterparties, if a non-registrant is

trading with a registered SD or MSP, the swap transactions entered into by those two parties would be subject to the new regulatory regime established by Section 4s of CEA.<sup>38</sup> For this reason, the Commission is focusing on phasing swap transaction compliance.

The Commission recognizes that a number of new regulations under Section 4s will apply to swap transactions where the counterparty to an SD or MSP is not registered with the Commission. In such cases, the Commission is affording more time for those transactions to be brought into compliance with the new regulations. Moreover, registered SDs or MSPs may require additional time to bring their transactions into compliance with respect to non-registrant counterparties that have hundreds or thousands of managed accounts, referred to as third-party subaccounts for the purposes of this proposal.

In many instances, as noted in the proposing release for § 23.504, counterparties already will have in place industry standard documentation in the form of the widely-used ISDA master agreement, definitions, schedules, confirmations, and credit support annex to document their trades. The Commission anticipates that some of this existing documentation will meet some of the requirements of proposed § 23.504. However, it may be necessary for parties to negotiate certain amendments or additional documentation to comply with the new rules. In these instances, and in instances where counterparties have not previously documented their trading relationship and/or individual transactions, the Commission proposes to afford relief in the form of additional time to comply.

## C. Implementation Phasing of the Margin Documentation Requirements Under Section 4s(e) of the CEA

### 1. Background on the Margin for Uncleared Swaps Requirements

Section 731 of the Dodd-Frank Act added a new Section 4s(e) to the CEA that explicitly requires the Commission to adopt rules establishing margin requirements for all registered SDs and MSPs that are not banks.<sup>39</sup> Under

<sup>31</sup> Section 712(d)(1) provides: "Notwithstanding any other provision of this title and subsections (b) and (c), the Commodity Futures Trading Commission and the Securities and Exchange Commission, in consultation with the Board of Governors [of the Federal Reserve System], shall further define the terms 'swap', 'security-based swap', 'swap dealer', 'security-based swap dealer', 'major swap participant', 'major security-based swap participant', and 'security-based swap agreement' in section 1a(47)(A)(v) of the Commodity Exchange Act (7 U.S.C. 1a(47)(A)(v)) and section 3(a)(78) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(78))." Section 721(c) provides: "To include transactions and entities that have been structured to evade this subtitle (or an amendment made by this subtitle), the Commodity Futures Trading Commission shall adopt a rule to further define the terms 'swap', 'swap dealer', 'major swap participant', and 'eligible contract participant'."

<sup>32</sup> Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant"; Proposed Rule, 75 FR 80174, Dec. 21, 2010 and Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 FR 29818, May 23, 2011.

<sup>33</sup> See Effective Date for Swap Regulation, 76 FR 42508, Jul. 19, 2011.

<sup>34</sup> Registration of Swap Dealers and Major Swap Participants, 75 FR 71379, Nov. 23, 2010.

<sup>35</sup> The Section 4s Requirements include capital and margin, reporting and recordkeeping, daily trading records, business conduct standards, documentation standards, risk management and trading duties, designation of a chief compliance officer, and segregation with regard to uncleared swaps. 75 FR at 71380.

<sup>36</sup> In accordance with the preamble to the Registration proposal, the Commission anticipates finalizing other Section 4s Requirements, such as those rules proposed under Section 4s(e) (capital

requirements), Section 4s(f) (reporting and recordkeeping), Section 4s(g) (daily trading records), Section 4s(h) (business conduct standards), Section 4s(j) (duties, including trading, risk management, disclosure of information, conflicts of interest, and antitrust considerations), and Section 4s(k) (designation of a chief compliance officer), and providing for specific compliance deadlines in the respective final implementing rulemakings based on the extensive public comment already received.

<sup>37</sup> 75 FR 80638, Dec. 22, 2010.

<sup>38</sup> Recognizing this reality, the Commission previously proposed rules under which SDs and MSPs would have policies and procedures to bring their transactions with all their counterparties into compliance with the requirements of Section 4s(i) of the CEA.

<sup>39</sup> Section 4s(e) applies a bifurcated approach that requires each SD and MSP for which there is a prudential regulator to meet margin requirements established by the applicable prudential regulator,

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Section 4s(e)(2)(B), the Commission is required to adopt rules for non-bank SDs and MSPs imposing “both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization.”

On April 28, 2011, the Commission issued proposed regulations to implement the margin requirements for uncleared swaps for SDs and MSPs for which there is no prudential regulator (referred to as “covered swap entities” or “CSEs” under the proposal).<sup>40</sup> The proposed Margin Requirements recognized that specific margin requirements would vary by the type of counterparty entering into a swap with a CSE. For instance, the proposed rules would not impose any margin requirements on swaps between CSEs and non-financial end users.<sup>41</sup>

The provisions of the proposed Margin Requirements include definitions (§ 23.150), documentation regarding credit support arrangements (§ 23.151), the specific margin requirements between CSEs and their counterparties (§§ 23.152–23.154), provisions for the calculation of initial margin (§ 23.155), provisions for the calculation of variation margin (§ 23.156), requirements for the forms of margin (§ 23.157), and custodial arrangement requirements (§ 23.158). Specific margin requirements vary by the type of counterparty with which a CSE is trading—another SD or MSP<sup>42</sup> (§ 23.152), a financial entity (§ 23.153), or a non-financial entity (§ 23.154).

As explained above with regard to the Trading Documentation rules, the Commission observes that no CSE could be required to comply with final Margin Requirements rules until (1) the Commission adopts further definitions of “swap,” “swap dealer,” and “major swap participant”; and (2) the Commission adopts registration rules for SDs and MSPs. As noted above, the

and each SD and MSP for which there is no prudential regulator to comply with Commission’s regulations governing margin.

<sup>40</sup> Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 75 FR 23732, Apr. 28, 2011.

<sup>41</sup> 76 FR at 23734.

<sup>42</sup> In some instances this SD or MSP counterparty may be subject to regulation by a prudential regulator. The margin rules proposed by the Commission and those proposed by the prudential authorities require any CSE to collect margin, but do not require a CSE to post margin. Under this approach, a non-bank SD or MSP will look to the Commission’s rules when calculating the margin that should be collected from its counterparty, and a bank SD or MSP will look to the prudential regulators’ rules when calculating the margin that should be collected from its counterparty. As a result, in a trade between a bank SD and a non-bank SD, the initial margin amounts collected by each side could differ depending on the applicable rules.

proposed Margin Requirements cross-reference certain provisions in the Trading Documentation rule. As a result, the final Trading Documentation rule would have to be published in the **Federal Register** prior to requiring compliance with the final Margin Requirements.<sup>43</sup>

## 2. Compliance Schedule for Margin Requirements Documentation—§ 23.175

In this further notice of proposed rulemaking, the Commission is proposing a compliance schedule, § 23.175, that is specific to the Margin Requirements of proposed § 23.150 through § 23.158. Under the proposed Margin Requirements, an SD or MSP for which there is no prudential regulator, is defined as a “covered swap entity.” For consistency, this term also would be used in the proposed compliance schedule. In order to achieve compliance with the Margin Requirement, a CSE would be required to execute documentation regarding credit support arrangements and custodial arrangements with its counterparties. This documentation, required by proposed § 23.151 and § 23.158, would specify in advance material terms such as how margin would be calculated, what types of assets would be permitted to be posted, what margin thresholds, if any, would apply, and where margin would be held. As stated in the proposal, having comprehensive documentation in place at the time of transaction execution would allow each party to a swap to manage its risks more effectively throughout the life of the swap and to avoid disputes regarding issues such as valuation.<sup>44</sup>

Under the proposed compliance schedule, a covered swap entity would be afforded ninety (90), one hundred eighty (180), or two hundred and seventy (270) days (depending on the identity of its counterparty) to come into compliance with all of the Margin Requirements. The categorization by type of counterparty is discussed further below.

### D. Three-Part Implementation Phasing

The Commission believes that it is in the public interest to afford SDs and MSPs over which the Commission has jurisdiction relief in the form of

<sup>43</sup> The Commission’s proposed capital rules for SDs and MSPs are related to the proposed Margin Requirements rules, but the margin rules are not dependent on implementation of the capital rule in order to take effect.

<sup>44</sup> 76 FR 23734. As stated in the proposal, margin requirements would also apply to swaps where one side of the trade is not registered with the Commission. 76 FR 23732–36.

additional time to comply with proposed rules related to Trading Documentation (§ 23.504) and Margin Requirements (§ 23.150–23.158), depending on the type of counterparty with which the SD or MSP is trading.

These proposed compliance schedules, §§ 23.575 and 23.175, seek to achieve the best balance among several goals. First, the Commission believes that SDs or MSPs may require additional time to work with certain market participants to bring their swaps into compliance with the new requirements of proposed Trading Documentation (§ 23.504) and Margin Requirements (§ 23.150–23.158). This is particularly true for those market participants that have hundreds or thousands of managed accounts, referred to as third-party subaccounts for the purposes of this proposal.

As one commenter noted, “[i]n the context of asset managers, the account set up process has to be multiplied over hundreds of subaccounts. Processing all of these subaccounts will take time even for the largest and most technologically advanced asset managers.”<sup>45</sup> In light of this, the Commission is proposing to afford SDs and MSPs with additional time to come into compliance with the requirements of Trading Documentation (§ 23.504) and Margin Requirements (§ 23.150–23.158) for swaps involving entities that are defined as “third-party subaccounts” because of the additional burden associated with documenting such accounts.

Moreover, several commentators emphasized the need to have adequate time to educate their clients regarding the new regulatory requirements.<sup>46</sup> For instance, market participants that may not be registered with the Commission would be less familiar with the new regulatory requirements. In addition, market participants with third-party subaccounts would have to educate additional clients. Accordingly, swaps involving either type of participant should be given additional time to comply with the new requirements.

Another goal of the proposed compliance schedule is derived from the Commission’s belief that it is important to have a cross-section of market participants involved at the outset of implementing the requirements under Trading Documentation (§ 23.504) and Margin

<sup>45</sup> Letter from Karrie McMillan, Investment Company Institute, dated June 10, 2011 at 9–10.

<sup>46</sup> See Letter from Financial Services Forum, Futures Industry Association, International Swaps and Derivatives Association, and Securities Industry Association, dated May 4, 2011; Letter from Karrie McMillan, Investment Company Institute, dated June 10, 2011 at 10–11.

Requirements (§§ 23.150–23.158).

Accordingly, the Commission proposes that the first phase of implementation include SDs, MSPs and “active funds” (a term that is defined and discussed further below) that are experienced, have the resources, and can come into compliance more readily than entities that trade swaps less frequently. The Commission believes that having a cross-section of market participants involved at the outset will facilitate the development of systems necessary for SDs and MSPs to achieve compliance with the new requirements.

The Commission proposes a compliance schedule that affords additional time for SDs and MSPs to come into compliance with the requirements of Trading Documentation (§ 23.504) and Margin Requirements (§§ 23.150–23.158) based on the type of counterparty with which they are trading. Market participants that are financial entities, as defined in Section 2(h)(7)(C) of the CEA, are grouped into the following four categories:

- Category 1 Entities include swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, or active funds.
- Category 2 Entities include commodity pools; private funds as defined in Section 202(a) of the Investment Advisors Act of 1940 other than active funds; employee benefit plans identified in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974; or persons predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956, *provided that* the entity is not a third-party subaccount.
- Category 3 Entities include Category 2 Entities whose positions are held as third-party subaccounts.
- Category 4 Entities includes any person not included in Categories 1, 2, or 3.

#### Phase 1—Category 1 Entities

Category 1 Entities include those dealers and major participants in the swap and security-based swap markets that will be required to register with the Commission or the Securities and Exchange Commission (SEC).<sup>47</sup> Under Title VII, these market participants will

be required to register with either the CFTC or SEC as a result of their swaps or security-based swaps activities. Based on their level of market experience, and based on their status as registrants, the Commission believes they should be capable of complying with proposed Trading Documentation (§ 23.504) and Margin Requirements (§§ 23.150–23.158) no later than 90 days from the date of adoption of final rules.

The Commission also is proposing to include those entities it defines as “active funds” in the first category of market participants. The proposed definition of “active fund” would mean any private fund as defined in section 202(a) of the Investment Advisors Act of 1940, that is not a third-party subaccount and that executes 20 or more swaps per month based on a monthly average over the 12 months preceding the publication of either § 23.504 or §§ 23.150–23.158, as applicable.<sup>48</sup> By including these entities in Category 1, the Commission seeks to achieve the goal of ensuring a cross-section of market participants are included at the outset of trading and margining documentation implementation.

The Commission is relying on the definition of private fund from Section 2(h)(7)(C) of the CEA, as well as Section 402 of the Dodd-Frank Act. However, the Commission is limiting the definition in two ways. First, the definition excludes third-party subaccounts, as discussed further below. Second, the definition is limited to those private funds that execute 20 or more swaps per month based on the average over the 12 months preceding either (1) the Commission’s adoption of § 23.150 through § 23.158 in the case of § 23.175; or (2) the Commission’s adoption of § 23.504 in the case of § 23.575. Based on a preliminary assessment, the Commission believes the proposed numerical threshold for active funds is appropriate because a private fund that conducts this volume of swaps would be likely to have: (1) Sufficient resources to enter into arrangements that comply with the Trading Documentation and Margin Requirements earlier than other types of market participants; and (2) sufficient market experience to contribute meaningfully to the “buy-side” perspective as industry standards are being developed.<sup>49</sup> In defining “active

fund” accordingly, the Commission believes it has included those market participants that are likely to be among the most experienced participants with expertise and resources needed to come into transaction compliance quickly.

#### Phase 2—Category 2 Entities

Next, the Commission proposes to phase in compliance for any swap transaction between an SD or MSP and a Category 2 Entity. The Commission is proposing to afford swap transactions between these types of market participants 180 days from the dates of adoption of Trading Documentation (§ 23.504) and Margin Requirements (§§ 23.150–23.158) to come into compliance. This additional time takes into consideration the fact that Category 2 Entities will not be required to be registered with the Commission and they may be less experienced and less frequent users of the swap markets than those in Category 1. Additionally, these financial entities may not have the same level of resources to review, analyze, negotiate, and enter into arrangements that comply with the new Trading Documentation and Margin Requirements as those in Category 1.

#### Phase 3—Category 3 and 4 Entities

Finally, the Commission proposes to afford an SD or MSP trading with a Category 3 or 4 Entity 270 days from adoption of final rules relating to Trading Documentation (§ 23.504) and Margin Requirements (§§ 23.150–23.158) to enter into arrangements that comply with the new rules.

The Commission is proposing to afford SDs and MSPs with additional time to work with entities that are defined as “third-party subaccounts” to bring their documentation into compliance. Under the proposed definition, a third-party subaccount is a managed account that requires specific approval by the beneficial owner of the account to execute documentation necessary for executing, confirming, margining, or clearing swaps. By way of non-exclusive example, if investment management firm X manages the assets of pension fund Y, and does so in a separate account that requires the approval of pension fund Y to execute necessary documentation, then that account would be afforded 270 days to come into compliance. On the other hand, if pension fund Y manages its own assets, it would fall within

<sup>47</sup> If a security-based swap dealer or a major security-based swap participant is not yet required to register with the SEC at such time as the Commission issues final rules § 23.504 or §§ 23.150–23.158, then the security-based swap dealer or a major security-based swap participant would be treated as a Category 2 Entity.

<sup>48</sup> It should be noted that many commodity pools meet the definition of private fund under section 202(a) of the Investment Advisors Act of 1940. Such a commodity pool would only be a Category 1 Entity if it met the other criteria of an active fund.

<sup>49</sup> The Commission is unaware of any position-level or transaction-level data on private fund swap

activity in a publicly available form. In order to determine private fund activity levels the Commission consulted with academics focusing their research in this area, with industry participants, and with groups that represent the industry.

Category 2 and be afforded 180 days to come into compliance. Likewise, if investment management firm X does not manage the assets of third parties, then it would fall within Category 2. The Commission is proposing to afford Category 3 an additional 90 days beyond the 180 days proposed for Category 2 because such entities may have documentation obligations for hundreds or even thousands of third-party subaccounts, and each such account must meet the requirements of Trading Documentation (§ 23.504) and Margin Requirements (§§ 23.150–23.158). For example, according to a statement made during the Joint SEC–CFTC Roundtable by Mr. William DeLeon of the firm Pacific Investment Management Company, LLC (PIMCO), PIMCO manages hundreds of third-party subaccounts, as defined above.<sup>50</sup>

The Commission is proposing to afford an SD or MSP trading with any other person (defined as a Category 4 Entity) 270 days to enter into arrangements that comply with the new rules.

The Commission stresses that nothing would prohibit any person from complying in advance of the proposed compliance schedule. Indeed, the Commission would encourage market participants that can come into compliance more quickly to do so.

#### *E. Comment Requested*

The Commission requests comment on all aspects of the proposed compliance schedules, §§ 23.175 and 23.575. The Commission may consider alternatives to the proposed compliance schedules and is requesting comment on the following questions:

- What, if any, other rules should have been taken into consideration when proposing an implementation schedule regarding margin or documentation requirements? If applicable, how should the implementation requirements of those other rules be taken into consideration?
- What factors, if any, would prevent an entity in any of the proposed categories from adhering to the compliance schedules proposed by the Commission? How much additional time would be needed to address these factors?
- Are there other considerations that the Commission should have taken into account when designing this tiered implementation schedule? Are the timeframes outlined in this implementation schedule adequate? If not, what alternative schedule should the Commission consider, and why?

- What other entities, if any, should be included in Category 1, 2, or 3, and why?

- What adjustments to the compliance schedule and/or other steps could the Commission take to ensure there is adequate representation from all market participants at the outset of implementing the requirements under Trading Documentation (§ 23.504) and Margin Requirements (§§ 23.150–23.158)?

- Is an entity's average monthly swap transaction activity a useful proxy for that entity's ability to comply with the Trading Documentation and Margin Requirements? Or whether an entity is required to be registered with the Commission (rather than whether an entity is already registered with the Commission)?

- Is the Commission's definition of "active fund" overly inclusive or under-inclusive? Should the numerical threshold for number of monthly swap transactions be higher or lower than 20? If so, why? Should the number of monthly swap transactions be linked to swap activity in a particular asset class?

- Should the Commission exclude from the definition of "active fund" any investment advisor of private funds acting solely as an advisor to private funds with assets under management in the United States of less than \$150,000,000, as provided for in the reporting exemption for private funds under Section 408 of the Dodd-Frank Act?

- Would it be more appropriate for the Commission to measure a market participant's level of swap activity by measuring notional turnover and/or open exposure as suggested by some commenters?<sup>51</sup>

- Are there any anticompetitive implications to the proposed compliance schedules? If so, how could the proposed rules be implemented to achieve the purposes of the CEA in a less anticompetitive manner? If so, please quantify those costs, if possible, and provide underlying data sources, assumptions, and calculations.

- Are there additional costs or benefits associated with the current proposal that the Commission has not already taken into account? Please discuss any such costs in detail and quantify in dollar terms, if possible.

- Are there any assumptions, including quantitative assumptions, underlying the Commission's cost benefit analysis that the Commission should consider?

- Should the Commission consider an alternative implementation schedule? Would such an alternative schedule reduce the costs market participants will bear? Please describe any such alternative implementation schedule in detail, including how it will reduce costs and the benefits it will likely deliver. If possible, please quantify the cost and benefits associated with any alternative. If providing dollar values, please describe any data sources, assumptions, and calculations used to generate them.

- Should a compliance schedule such as those proposed herein apply to the disclosure and documentation requirements proposed in the Business Conduct Standards for Counterparties proposal? If so, should the compliance schedule be adjusted, and in what manner?

### **III. Related Matters**

#### *A. Regulatory Flexibility Act*

The Regulatory Flexibility Act requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.<sup>52</sup> The rules proposed by the CFTC provide compliance schedules for certain new statutory requirements of the Dodd Frank Act and do not by themselves impose significant new regulatory requirements. Accordingly, the Chairman, on behalf of the CFTC, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules will not have a significant economic impact on a substantial number of small entities. The CFTC invites public comment on this determination.

#### *B. Paperwork Reduction Act*

The Paperwork Reduction Act ("PRA")<sup>53</sup> imposes certain requirements on Federal agencies (including the Commission) in connection with conducting or sponsoring any collection of information as defined by the PRA. This Further Notice of Proposed Rulemaking, if approved, would not require a new collection of information from any persons or entities.

#### *C. Consideration of Costs and Benefits*

Section 15(a) of the CEA<sup>54</sup> requires the Commission to consider the costs and benefits of its action before promulgating a regulation under the CEA. Section 15(a) of the CEA specifies

<sup>52</sup> 5 U.S.C. 601 *et seq.*

<sup>53</sup> 44 U.S.C. 3507(d).

<sup>54</sup> 7 U.S.C. 19(a).

<sup>50</sup> Day-2 Roundtable Tr. at 62.

<sup>51</sup> Letter from Adam C. Cooper, Citadel, dated June 3, 2011, Appendix B.



that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular regulation is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the Act.

The purpose of this proposed rule is to afford SDs and MSPs additional time to comply with the Trading Documentation and the Margin Requirements beyond that which is provided for in the Dodd-Frank Act. Section 754 of the Dodd-Frank Act provides that required rulemakings can be considered to be effective 60 days after publication of the final rule or regulation. Without the proposed rule, SDs and MSPs could be required to comply with Trading Documentation (§ 23.504) and Margin Requirements (§§ 23.150–23.158) rules without any implementation phasing of the sort provided for by the proposed compliance schedules.

The Commission recognizes that requiring immediate compliance with the new requirements could indirectly impose costs on market participants that may not be registered with the Commission and those market participants that have hundreds or thousands of third-party subaccounts to bring into compliance. Accordingly, and in an effort to protect the public interest by facilitating an orderly transition to a new regulatory environment, the Commission's proposed compliance schedules would provide a substantial benefit in that they would afford SDs and MSPs adequate time to modify or create the requisite documentation in collaboration with their counterparties.

#### 1. Protection of Market Participants and the Public

The Trading Documentation (§ 23.504) and Margin Requirements (§§ 23.150–23.158) rules for which the Commission has proposed compliance schedules would encourage transparency in the swap market by requiring that SDs, MSPs, and their counterparties clarify, in writing, many aspects of their trading relationship prior to entering into a swap, and also that they clarify many specific details

related to margining their swaps. The proposed compliance schedules would further the objectives of Sections 4s(e) and 4s(i) of the CEA by establishing an orderly process for their implementation. The proposed compliance schedules have several benefits that contribute to protection of the public as well as market participants.

It is in the public interest that the largest and most active participants in the swap markets come into compliance with Sections 4s(e) and 4s(i) of the CEA as soon as possible, in order to facilitate an orderly transition to the new regulatory environment for swaps. The proposed compliance schedules would prioritize compliance for Category 1 Entities because these entities are likely responsible for a large portion of the swap transactions occurring in this market. But the schedule would do so in a way that still safeguards the interests of the Category 1 Entities by providing the additional time that these entities need in order to document new trading relationship and margining arrangements required by Sections 4s(e) and 4s(i) of the CEA.

The additional time provided by the proposed compliance schedules would create several benefits for the SDs, MSPs, and their counterparties. First, if market participants were concerned that they might not be able to meet statutory compliance timelines, it is likely that they would incur additional costs associated with the potential lack of regulatory compliance. Providing additional time for compliance through the proposed compliance schedule would reduce the costs that market participants may incur mitigating risks during the transition period, and would re-direct those resources to achieving compliance with the new rules.

Second, if Category 2, 3, or 4 Entities want to come into compliance ahead of the timeframes proposed for their SD or MSP counterparties through the compliance schedules, they may work with their SD and MSP counterparties to do so. Category 2, 3, or 4 Entities may wish to achieve compliance earlier in order to achieve the benefits associated with greater clarity in their trading relationships and margin arrangements for non-cleared swaps. They also may wish to take advantage of newly developed template agreements as they develop. Such early compliance by market participants would provide additional protection for the public by decreasing the risks associated with failing to document trading relationships and swap transactions properly, as well as decreasing the risks associated with failing to collateralize

the credit exposure posed by uncleared swaps. Additionally, early compliance would have the benefit of increasing clarity about how margin will be handled for non-cleared swaps.

Category 3 Entities have the additional challenge of transitioning hundreds, and in some cases, thousands of subaccounts into compliance with the new documentation requirements for trading relationships and margining non-cleared swaps. The proposed compliance schedules would afford Category 3 Entities additional time to educate their customers about the new requirements, and then negotiate and formalize new trading and margining agreements between their customers and SDs or MSPs. Each of these tasks requires time. By giving Category 3 Entities and their counterparties 270 days to come into compliance, the Commission is attempting to provide adequate time for these entities to come into compliance without the need for significant additional legal assistance. The Commission also is attempting to avoid the risk of inadequate documentation and inappropriate margining arrangements that may result from a more rushed process. Both of these results would tend to reduce costs and risk for both SDs and MSPs and their Category 3 Entities counterparties.

As far as costs are concerned, by establishing a 3-month, 6-month, and 9-month compliance schedule for SDs and MSPs to achieve compliance with their counterparties that are Category 1, Category 2, and Category 3 and 4 Entities, respectively, the proposed compliance schedule would delay certain benefits that would result from more timely and accurate documentation by SDs and MSPs, as well as timely compliance with Margin Requirements for non-cleared swaps. Those costs primarily include a delay in decreasing the risks associated with the failure to document trading relationships and swap transactions properly, as well as a delay in terms of decreasing the risks associated with not collateralizing the credit exposure posed by uncleared swaps.

The proposed compliance schedules seek to balance the cost to SDs, MSPs, and the Category 1 Entities that would be associated with bearing a larger proportion of the "start-up" costs associated with most promptly implementing the Trading Documentation and Margin Requirements. SDs, MSPs, and Category 1 Entities are the entities likely to expend the most resources establishing industry standard agreements that can then be used by other market participants. It is appropriate for the



entities that are likely to be among the most active participants in these markets to shoulder a larger percentage of the relatively fixed start-up costs.

## 2. Efficiency, Competitiveness, and Financial Integrity of the Markets

The SDs, MSPs, and Category 1 Entities that constitute the first phase under the proposed compliance schedules will be likely to work together to establish methods for compliance that other market participants may later consider. The experience with swaps that the first group of market participants brings to this process should help to ensure the integrity and effectiveness of their solutions. These solutions will likely be helpful to other market participants that comply later. This approach is likely to result in benefits for a broad group of market participants.

Moreover, it is critical that a cross-section of market participants is involved in developing the solutions that become industry conventions in order to ensure that those approaches promote the efficiency, competitiveness, and integrity of participants on both the buy-side and sell-side. Category 1 includes market participants from both sides, which helps ensure that the interests of both will be represented well as the industry identifies and solves the problems that are necessary for compliance.

With respect to the activities of Category 1 participants, providing them 90 days to come into compliance after the Trading Documentation (§ 23.504) and Margin Requirements (§§ 23.150–23.158) are published in the **Federal Register** would create some time and opportunity for industry coordination as multiple participants, representing both the sell-side and buy-side of the market, identify shared questions and work to develop sound answers. This is likely to facilitate better compliance systems and processes, which reduces the start-up costs of implementing new regulations for these and other entities, which is expected to lower costs to the public by promoting standardization.

Lastly, in the absence of the proposed compliance schedules, some entities have expressed concern that they would be unable to comply with the new requirements and would choose to leave the swap market altogether or avoid the market for some period of time. If this occurred, it could reduce liquidity and might increase spreads in the market. By providing additional time for compliance, this rule reduces the chance that these adverse effects will occur in the swap market and facilitates

an orderly transition to the new regulatory environment.

As for costs related to the efficiency, competitiveness, and financial integrity of the markets, the proposed compliance schedules would allow for delayed compliance dates for new Trading Documentation and Margin Requirements. The schedules would delay the benefits of the new requirements that would come from more expeditious implementation.

## 3. Price Discovery

As noted above, the Trading Documentation rule contains a requirement that an SD or MSP and its counterparty agree on how they will value each swap transaction into which they enter from the point of execution until the termination, maturity, or expiration of the swap. Prompt implementation of this requirement would facilitate price discovery between the counterparties to a swap. Delay in implementing this provision may inhibit price discovery to the extent that counterparties fail to value their swaps on a timely and accurate basis. In this way, the proposed rule would delay the benefits of increased price transparency that could flow from a more expeditious implementation of the Trading Documentation rule. Additionally, a disorderly implementation may inhibit price discovery to the extent that counterparties fail to value their swaps on a timely and accurate basis; whereas, an orderly implementation process would promote communication between counterparties, which is essential to price discovery.

## 4. Sound Risk Management Practices

To the extent that the proposed compliance schedule would delay implementation of the Trading Documentation (§ 23.504) and Margin Requirements (§§ 23.150–23.158) rules, the swap market could suffer costs in terms of poor risk management resulting from a failure to document trading relationships and swap transactions properly, as well as from failure to collateralize the outstanding credit exposure posed by uncleared swaps through appropriate margining.

However, there are risk management benefits to be gained from the proposed compliance schedule. For instance, if SDs and MSPs were expected to comply with Trading Documentation (§ 23.504) and Margin Requirements (§§ 23.150–23.158) on timelines that they could not meet, it is possible that some firms may avoid the swap market for a period of time, which could expose them to risks they could have otherwise used swaps to mitigate. Therefore, by providing a

timetable for orderly implementation, this rule could encourage continued participation in the swap markets and the continued use of swaps for risk mitigation purposes.

## 5. Other Public Interest Considerations

There are public interest benefits to phasing in compliance using the implementation structure proposed in this release. The proposed implementation structure generally allows market participants to comply with the requirements of Dodd-Frank as quickly and efficiently as possible and thereby provides a sound basis for achieving the overarching Dodd-Frank goals of risk reduction and increased market transparency.

In sum, the Commission has considered the costs and benefits as required by Section 15(a) and is proposing the compliance schedules discussed herein. The Commission invites public comment on its cost-benefit considerations. Commenters are also invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the proposal with their comment letters.

## List of Subjects in 17 CFR Part 23

Antitrust, Commodity futures, Conduct standards, Conflicts of interest, Major swap participants, Reporting and recordkeeping, Swap dealers, Swaps.

For the reasons stated in the preamble, 17 CFR part 23 is proposed to be amended as follows:

## PART 23—SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

1. The authority citation for part 23 continues to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 6, 6a, 6b–1, 6c, 6p, 6r, 6s, 6t, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21.

2. Add § 23.175 to subpart E to read as follows:

### § 23.175 Compliance schedule.

(a) *Definitions.* For the purposes of this rule:

*Active Fund* means any private fund as defined in section 202(a) of the Investment Advisors Act of 1940, that is not a third-party subaccount and that executes 20 or more swaps per month based on a monthly average over the 12 months preceding the publication of § 23.150 through § 23.158 in the **Federal Register**.

*Category 1 Entity* means (1) A swap dealer, (2) a security-based swap dealer; (3) a major swap participant; (4) a major security-based swap participant; or (5) an active fund.

**Category 2 Entity** means (1) A commodity pool; (2) a private fund as defined in section 202(a) of the Investment Advisors Act of 1940 other than an active fund; (3) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974; or (4) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956, *provided that*, in each case, the entity is not a third-party subaccount.

**Category 3 Entity** means a Category 2 Entity whose positions are held as a third-party subaccount.

**Category 4 Entity** means any person not included in Categories 1, 2, or 3.

**Covered swap entity** means a swap dealer or major swap participant for which there is no prudential regulator.

**Third-party Subaccount** means a managed account that requires specific approval by the beneficial owner of the account to execute documentation necessary for executing, confirming, margining, or clearing swaps.

(b) **Compliance Schedule.** The following schedule for compliance with the requirements of § 23.150 through § 23.158 shall apply:

(1) For swap transactions with a Category 1 Entity, a covered swap entity shall comply with the requirements of § 23.150 through § 23.158 no later than ninety (90) days from the date of publication of such requirements in the **Federal Register**.

(2) For swap transactions with a Category 2 Entity, a covered swap entity shall comply with the requirements of § 23.150 through § 23.158 no later than one hundred and eighty (180) days from the date of publication of such requirements in the **Federal Register**.

(3) For swap transactions with a Category 3 Entity or a Category 4 Entity, a covered swap entity shall comply with the requirements of § 23.150 through § 23.158 no later than two hundred and seventy (270) days from the date of publication of such requirements in the **Federal Register**.

(c) Nothing in this rule shall prohibit any person from complying voluntarily with the requirements of § 23.150 through § 23.158 sooner than the compliance schedule provided in paragraph (b).

3. Add new § 23.575 to part 23, subpart I, to read as follows:

**§ 23.575 Compliance schedule.**

(a) **Definitions.** For the purposes of this rule:

**Active Fund** means any private fund as defined in section 202(a) of the Investment Advisors Act of 1940, that is not a third-party subaccount and that executes 20 or more swaps per month based on a monthly average over the 12 months preceding the publication of § 23.504 in the **Federal Register**.

**Category 1 Entity** means (1) A swap dealer; (2) a security-based swap dealer; (3) a major swap participant; (4) a major security-based swap participant; or (5) an active fund.

**Category 2 Entity** means (1) A commodity pool; (2) a private fund as defined in section 202(a) of the Investment Advisors Act of 1940 other than an active fund; (3) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974; or (4) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956, *provided that*, in each case, the entity is not a third-party subaccount.

**Category 3 Entity** means a Category 2 Entity whose positions are held as a third-party subaccount.

**Category 4 Entity** means any person not included in Categories 1, 2, or 3.

**Third-party Subaccount** means a managed account that requires specific approval by the beneficial owner of the account to execute documentation necessary for executing, confirming, margining, or clearing swaps.

(b) **Compliance schedule.** The following schedule for compliance with the requirements of § 23.504 shall apply:

(1) For swap transactions with a Category 1 Entity, a swap dealer or major swap participant shall comply with the requirements of § 23.504 no later than ninety (90) days from the date of publication of such requirements in the **Federal Register**.

(2) For swap transactions with a Category 2 Entity, a swap dealer or major swap participant shall comply with the requirements of § 23.504 no later than one hundred and eighty (180) days from the date of publication of such requirements in the **Federal Register**.

(3) For swap transactions with a Category 3 Entity or a Category 4 Entity, a swap dealer or major swap participant shall comply with the requirements of § 23.504 no later than two hundred and seventy (270) days from the date of publication of such requirements in the **Federal Register**.

(c) Nothing in this rule shall prohibit any person from complying voluntarily with the requirements of § 23.504

sooner than the compliance schedule provided in paragraph (b).

Issued in Washington, DC, on September 8, 2011, by the Commission.

**David A. Stawick,**

*Secretary of the Commission.*

**Appendices To Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements Under Section 4s of the CEA—Commissioners Voting Summary and Statements of Commissioners**

**Note:** The following appendices will not appear in the Code of Federal Regulations

**Appendix 1—Commissioners Voting Summary**

On this matter, Chairman Gensler and Commissioners Dunn, Sommers, and Chilton voted in the affirmative; Commissioner O'Malia voted in the negative.

**Appendix 2—Statement of Chairman Gary Gensler**

I support this proposal to establish schedules to phase in compliance with previously proposed requirements, including the swap trading relationship documentation requirement and the margin requirements for uncleared swaps. The proposal would provide greater clarity to swap dealers and major swap participants regarding the timeframe for bringing their swap transactions into compliance with new documentation and margining rules. The proposal also would make the market more open and transparent, while giving market participants an adequate amount of time to comply. The proposal would help facilitate an orderly transition to a new regulatory environment for swaps.

**Appendix 3—Statement of Commissioner Scott O'Malia**

I respectfully dissent from the Commission's decision today to approve for **Federal Register** publication two rule proposals related to implementation entitled "Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA" and "Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements under Section 4s of the CEA." For quite some time, I have been asking that the Commission publish for notice and comment a comprehensive implementation schedule that addresses the entire mosaic of rule proposals under the Dodd-Frank Act. I believe the Commission should have proposed a comprehensive schedule that detailed, at a minimum:

- For each registered entity (e.g., swap dealer and major swap participants), compliance dates for each of its entity-specific obligations (e.g., all obligations under Section 4s of the Commodity Exchange Act) under Dodd-Frank; and
- For each market-wide obligation (e.g., the clearing and trading mandates), the

entities affected (whether registered or unregistered) along with appropriate compliance dates.

Such a schedule would have complemented and informed existing proposals and provided structure to future determinations. Additionally, a proposal regarding such a schedule should have adequately analyzed the costs and benefits of alternatives, including appropriate quantification. Unfortunately, the two rule proposals that the Commission approved today fail to either propose a comprehensive schedule or provide an adequate cost benefit analysis.

The Commission's proposals also fail to request comment on a number of issues that I believe are important considerations in developing an implementation plan. As a result, I am encouraging commenters to submit responses to the questions below as part of their comments on the two rule proposals.

*Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA*

- Should the Commission provide guidance on how it will make and communicate a mandatory clearing determination prior to considering the first such determination? If so, what information should be included in guidance?

- As section II(E) of the proposal states: "When issuing a mandatory clearing determination, the Commission would set an effective date by which all market participants would have to comply. In other words, the proposed compliance schedules would be used only when the Commission believes that phasing is necessary based on the considerations outlined in this release. The Commission will provide the public with notice of its intent to rely upon the compliance schedule pursuant to the process outlined in § 39.5(b)(5)." To afford more certainty to market participants, should the Commission instead create a presumption that it will rely on the compliance schedule for each mandatory clearing determination that it issues, unless it finds that the compliance schedule is not necessary to achieve the benefits set forth in the proposal (e.g., facilitating the transition to the new regulatory regime established by the Dodd-Frank Act in an orderly manner that does not unduly disrupt markets and transactions)?

- What, if any, other issues not addressed in current proposed or final rulemakings should the Commission have taken into consideration when proposing the compliance schedule? For example, should the Commission have considered the extent to which its clearing and trade execution requirements apply to entities and transactions located outside the United States? Also, should the Commission have considered the extent to which such requirements apply to transactions between affiliates (whether domestic or cross-border)? If applicable, how should the Commission adjust the proposed compliance schedule to account for such issues?

- What, if any, adjustments should the Commission make to the proposed

compliance schedule for trade execution requirements if the Commission makes a determination that a group, category, type, or class of swaps, rather than a specific swap, is subject to mandatory clearing? Would such adjustments vary depending on the manner in which the Commission defines group, category, type, or class?

*Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements Under Section 4s of the CEA*

- What, if any, other issues not addressed in current proposed or final rulemakings should the Commission have taken into consideration when proposing the compliance schedule? For example, should the Commission have considered the extent to which its documentation and margin requirements apply to entities and transactions located outside the United States? Also, should the Commission have considered the extent to which such requirements apply to transactions between affiliates (whether domestic or cross-border)? If applicable, how should the Commission adjust the proposed compliance schedule to account for such issues?

Finally, I want to be clear that I support completing the final Dodd-Frank rulemakings in a reasonable time frame. I believe that the timely implementation of such rulemakings is important. Knowing when and how the markets are required to do what is vital to the success of implementing the new market structure required under the Dodd-Frank Act. When billions of dollars are at stake, you simply do not rely on guesses and estimates based on vague conditions.

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## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Parts 37, 38, and 39

**RIN 3038-AD60**

#### Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The Commodity Futures Trading Commission (Commission or CFTC) is proposing regulations that would establish a schedule to phase in compliance with certain new statutory provisions enacted under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). These provisions include the clearing requirement under new section 2(h)(1)(A) of the Commodity Exchange Act (CEA or Act), and the trade execution requirement under new section 2(h)(8)(A) of the CEA. The

proposed schedules would provide relief in the form of additional time for compliance with these requirements. This relief is intended to facilitate the transition to the new regulatory regime established by the Dodd-Frank Act in an orderly manner that does not unduly disrupt markets and transactions. The Commission requests comment on the proposed compliance schedules for these clearing and trade execution requirements.

**DATES:** Submit comments on or before November 4, 2011.

**ADDRESSES:** You may submit comments, identified by RIN number 3038-AD60 and Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA, by any of the following methods:

- *Agency Web site*, via its Comments Online process at <http://comments.cftc.gov>. Follow the instructions for submitting comments through the Web site.

- *Mail*: David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

- *Hand Delivery/Courier*: Same as mail above.

- *Federal eRulemaking Portal*: <http://www.regulations.gov>. Follow the instructions for submitting comments.

Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to <http://www.cftc.gov>. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that may be exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the established procedures in § 145.9 of the Commission's regulations, 17 CFR 145.9.

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from <http://www.cftc.gov> that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other