

# ClientAlert

## Financial Markets Developments

Capital Markets/Derivatives  
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### CFTC and SEC Provide Temporary Relief From Swap Regulation

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") establishes a new regime for the regulation of over-the-counter derivatives. The Act gives jurisdiction to the Commodity Futures Trading Commission (the "CFTC") over the regulation of swaps and to the Securities and Exchange Commission (the "SEC" and, together with the CFTC, the "Commissions") over the regulation of security-based swaps. Jurisdiction for the regulation of mixed swaps is shared between the CFTC and the SEC. The Act, among other things, amends the Commodity Exchange Act (the "CEA") to establish a comprehensive new regulatory framework for swaps and amends the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") to expand the regulation of the security-based swaps market. Sections 754 and 774 of the Act provide that, unless otherwise provided, the provisions of Subtitle A and B of Title VII of the Act shall take effect on the later of 360 days after the date of enactment or, to the extent a provision requires rulemaking, not less than 60 days after the publication of the final rule implementing such provision. The effect of Sections 754 and 774 is that a number of provisions, including numerous amendments to the CEA and compliance obligations under the Exchange Act, were due to become effective on July 16, 2011 (the "Effective Date") unless the CFTC and SEC intervened.

#### The CFTC Order

On June 17, 2011, the CFTC issued a proposed order<sup>1</sup> (the "Proposed Order") granting temporary exemptive relief from certain requirements of the CEA, as amended by the Act, that would otherwise become effective on the Effective Date. The Proposed Order was issued by the CFTC under Section 712(f) of the Act and pursuant to the CFTC's exemptive authority under Section 4(c) CEA. Following a comment period, on July 14, 2011 the CFTC issued a final order (the "Final Order")<sup>2</sup> under the same authority, which effectively confirmed the provisions of the Proposed Order by providing that the effective date for various provisions under Title VII would be delayed beyond the Effective Date.

The Final Order categorizes the provisions of Title VII of the Act as follows:

Category 1: provisions that require rulemaking and do not take effect on July 16, 2011;<sup>3</sup>

Category 2: provisions that are self-effectuating and that refer to terms that must be further defined;



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<sup>1</sup> Effective Date for Swap Regulation, 76 FR 35372, June 17, 2011.

<sup>2</sup> Effective Date for Swap Regulation 76 FR 42508, July 14, 2011.

<sup>3</sup> For example, new section 4s(a) governing registration of swap dealers and major swap participants.

Category 3: provisions that are self-effectuating, do not refer to terms that must be defined and repeal current law; and

Category 4: provisions that are self-effectuating and do not refer to terms that must be defined.

Category 1 provisions require additional rulemaking and therefore do not become effective until 60 days after the publication of the relevant final rules. Category 1 provisions are therefore outside the scope of the Final Order. Category 1 covers most of the core reforms provided for by the Act such as margin and capital requirements, swap reporting, mandatory clearing, exchange trading and registration of swap dealers and major swap participants which means that a significant number of the rules required pursuant to the Act will not come into force on the Effective Date. Category 4 provisions also fall outside the scope of the Final Order as they are self-effectuating and do not require further rulemaking. The CFTC has stated that it does not believe that such provisions will cause undue disruption by requiring compliance on the Effective Date and therefore such provisions will take effect on the Effective Date. Lists of Category 1 and Category 4 provisions were published by the CFTC on its website on June 14, 2011.<sup>4</sup> In addition, the Final Order does not apply to or affect any provisions of Title VII that have already become effective; such provisions remain in effect.

### Part I - Category 2 Provisions

In the Final Order, the CFTC confirmed that it will temporarily exempt persons or entities from the provisions of the CEA where such provisions refer to one or more terms that are required to be further defined, such as the term “swap”, “swap dealer” and “eligible contract participant”. Thus, for example, any registration requirement that is triggered in relation to a “swap” will not take effect because the term “swap” has yet to be defined. The exemptive relief from such provisions applies only with respect to those requirements or portions of such provisions that specifically relate to such referenced terms. Such provisions technically take effect on the Effective Date, but have no legal effect to the extent they rely on terms that must be further defined by the CFTC. Section 712(d)(1) of the Act requires the Commissions to further define such terms and the Commissions have issued proposed rules<sup>5</sup> in relation to such definitions however such rules were not finalized by the Effective Date.<sup>6</sup>

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<sup>4</sup> <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cat1requiredrulemakings061411.pdf> and <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cat4requiredrulemakings061411.pdf>

<sup>5</sup> 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.

The exemptive relief set out in the Final Order in relation to Category 2 provisions will expire on the earlier of December 31, 2011 or the date when the final rulemaking in respect of such definitions becomes effective. The Final Order confirms that the CFTC can extend the deadline, if necessary, beyond December 31, 2011.

### Part II – Category 3 Provisions

Part II of the Final Order addresses those provisions of the CEA that apply to certain agreements, contracts and transactions in exempt or excluded commodities which would have been repealed on the Effective Date because of amendments to the CEA made by the Act.

Prior to the Effective Date, the CEA excluded certain transactions from CFTC oversight.<sup>7</sup> As a result of the Act, such exclusions were due to be removed on the Effective Date causing uncertainty for those persons who relied on the CEA exclusions (and who do not satisfy the Part 35 requirements<sup>8</sup>). To preserve the status-quo, the Final Order exempts a transaction in exempt or excluded (but not certain enumerated agricultural commodities)

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<sup>6</sup> The CFTC staff has issued a “no action” letter which addresses certain provisions that fall under Category 2 and for which the CFTC believes that it did not have authority under Section 4(c) to grant exemptive relief meaning that such provisions would come into force on the Effective Date. Specifically, the no-action letter provides that the Division of Market Oversight and the Division of Clearing and Intermediary Oversight would not recommend that the CFTC commence an enforcement action against any person for failure to comply with: (1) section 4s(l) of the CEA, which imposes upon swap dealers and major swap participants certain segregation requirements with respect to collateral for uncleared swaps; (2) section 5b(a) of the CEA, which requires a derivatives clearing organization to register with the CFTC in order to clear swaps; and (3) section 4s(k) of the CEA, which provides for the duties and designation of a chief compliance officer for swap dealers and major swap participants. The staff no-action letter does not limit the CFTC’s applicable anti-fraud and anti-manipulation authority. The provisions of the no-action letter expire on December 31, 2011. A copy of the draft letter is available at [www.cftc.gov/ucm/groups/public/@newsroom/documents/file/noaction061411.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/noaction061411.pdf) (last updated on June 30, 2011).

<sup>7</sup> See sections 2(d)(1) and (2), 2(g), 2(h)(1) and (2), 2(h)(3)-(7), 5(d) and 2(e) CEA.

<sup>8</sup> The removal of these provisions does not affect Part 35 of the CFTC Regulations which will continue in effect until withdrawn, amended or replaced by the CFTC. Therefore, transactions that satisfy all of the conditions of Part 35 will continue to be eligible for the exemptions contained in Part 35. Part 35 was issued in 1993 and provides a broad exemption from the CEA for individually negotiated, non-standardized swap agreements between eligible swap participants. Pursuant to Part 35.2, a swap agreement is exempt from the provisions of the CEA (other than anti-manipulation provisions) if: (a) the swap agreement is entered into solely between eligible swap participants at the time such persons enter into the swap agreement; (b) the swap agreement is not part of a fungible class of agreements that are standardized as to their material economic terms; (c) the creditworthiness of any party having an actual or potential obligation under the swap agreement would be a material consideration in entering into or determining the terms of the swap agreement, including pricing, cost, or credit enhancement terms of the swap agreement; and (d) the swap agreement is not entered into and traded on or through a multilateral transaction execution facility. Paragraphs (b) and (d) of Rule 35.2 do not preclude arrangements or facilities between parties to swap agreements that provide for netting of payment obligations resulting from such swap agreements.

commodities and any person or entity offering or entering into such transaction from the CEA (other than the CEA's anti-fraud and anti-manipulation enforcement provisions) following the Effective Date if the transaction otherwise would comply with Part 35, notwithstanding that: (1) the transaction may be executed on a multilateral transaction execution facility; (2) the transaction may be cleared; (3) persons offering or entering into the transaction may be eligible contract participants as defined in the CEA (and as defined prior to the Effective Date); (4) the transaction may be part of a fungible class of agreements that are standardized as to their material economic terms; and/or (5) no more than one of the parties to the transaction is entering into the transaction in conjunction with its line of business, but is neither an eligible contract participant nor an eligible swap participant, and the transaction was not and is not marketed to the public. The Final Order states that it does not affect the availability of Parts 32<sup>9</sup> and 35 to transactions that fall within the respective provisions but makes clear, however, that all transactions are subject to the new anti-fraud and anti-manipulation rules.<sup>10</sup>

The exemptive relief provided in Part II of the Final Order expires on the earlier of the repeal of Part 35 or December 31, 2011. The CFTC has proposed the repeal of Part 35; however such repeal is not yet effective.

The Final Order does not provide a comprehensive sequence of final rulemaking (as requested by market participants) and therefore a degree of uncertainty remains to the extent that rules and definitions are not finalized by December 31, 2011. It remains to be seen whether exemptive relief will need to be reconsidered by the CFTC in December.

## The SEC Rules and Orders

Title VII of the Act amends the Securities Act and the Exchange Act to substantially expand the regulation of the security-based swaps market. Among other things, Title VII of the Act imposes registration requirements on security-based swap dealers and major security-based swap participants; imposes reporting requirements on those entities that clear security-based swaps; and provides that security-based swaps must, in certain circumstances, be traded on an exchange. The Act also amends the Securities Act and the Exchange Act to include security-based swaps in the definition of "security". Pursuant to its exemptive authority under Section 36 of the Exchange Act and other available authority the SEC has taken steps to provide appropriate temporary relief in relation to security-based swaps. The intention of the SEC in publishing the recent rules and orders is to preserve the status-quo until final rules are put in place.

### Exemptive Order

On June 15, 2011 the SEC published a proposed order granting temporary exemptive relief in relation to security-based swaps and the relevant provisions of the Act which were to become effective on the Effective Date.<sup>11</sup> On July 1, 2011, following a comment period in relation to the proposed order, the SEC issued an exemptive order (the "SEC Order") granting temporary exemptive relief from compliance with certain Exchange Act and Securities Act provisions that would otherwise apply when the revised definition of "security" took effect on the Effective Date. For example, the SEC Order allows a person who was an "eligible contract participant" prior to the Effective Date but who may no longer be an "eligible contract participant" when such term is redefined, to continue transacting as if such person were an "eligible contract participant" until such time as the revised definition of "eligible contract participant" is finalized. The SEC Order will remain in effect until the compliance date for the relevant final rules that further define "security-based swap" and "eligible contract participant" or, in some instances, until compliance deadlines under the applicable rules are effective.

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<sup>9</sup> The Final Order confirms that parties may continue to rely upon the Part 32 Rules that govern commodity options (on certain enumerated agricultural commodities) until such time as those rules are withdrawn, amended, or replaced. This is relevant for options on enumerated agricultural commodities, which are not covered by Part 35.

<sup>10</sup> Note that such provisions require rulemaking and therefore fall within Category 1.

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<sup>11</sup> Order Pursuant to Sections 15F(b)(6) and 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, and Request for Comment, 76 FR 36287, June 22, 2011.

### Interim Final Rules

On July 11, 2011, the SEC adopted interim final rules<sup>12</sup> (the “IFRs”) providing exemptions under the Securities Act, the Exchange Act and the Trust Indenture Act of 1939 (the “TIA”) for those security-based swaps that are “security-based swap agreements” (as defined prior to the Effective Date) and that will be defined as “securities” under the Exchange Act on the Effective Date. The IFRs exempt offers and sales of security-based swaps from the provisions of the Securities Act, other than the anti-fraud provisions of Section 17(a), the registration requirements of the Exchange Act and the provisions of the TIA. The exemptions under the IFRs are effective as of July 11, 2011 and will remain in effect until the compliance date for final rules that the SEC adopts further defining the terms “security-based swap” and “eligible contract participant.” Comments were solicited by the SEC pursuant to the IFRs and the comment period closes on August 15, 2011.

### Securities Act Rule 240

The SEC has adopted Securities Act Rule 240, which exempts the offer or sale of a security-based swap from compliance with all provisions of the Securities Act (except the anti-fraud and anti-manipulation provisions of Section 17(a)) as long as the security-based swap is entered into between eligible contract participants (as such term is defined prior to the Effective Date). Further, pursuant to Securities Act Rule 240, a security-based swap will be exempt from the registration requirements of the Securities Act if it would have been a “security-based swap agreement” under the Securities Act prior to the Effective Date and is entered into between eligible contract participants (as that term was defined prior to the Effective Date).

### Exchange Act Rule 12a-11 and Rule 12h-1(i)

The SEC also adopted interim final Exchange Act Rule 12a-11 to exempt any security-based swap offered and sold in reliance on Securities Act Rule 240 from the provisions of Section 12(a) of the Exchange Act. According to the SEC, this exemption is intended to allow trading activities relating to those security-based swaps that under current law are security-based swap agreements with eligible contract participants to continue, provided the parties rely on the exemption under Securities Act Rule 240 with respect to such security-based swaps.

The SEC also adopted an interim final amendment to Exchange Act Rule 12h-1 to exempt any security-based swap offered and sold in reliance on Securities Act Rule 240 from the provisions of Section 12(g) of the Exchange Act.

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12 Exemptions for Security-Based Swaps, 76 FR 40605, July 11, 2011.

### Trust Indenture Act Rule 4d-12

Further, the SEC adopted an interim final rule pursuant to Section 304(d) TIA, which provides that any security-based swaps offered or sold in reliance of Securities Act Rule 240 are exempt from the provisions of the TIA.

### Extension of Exemptive Relief for Certain Eligible Credit Default Swaps

Under Title VII of the Act, certain credit default swaps will become security-based swaps and therefore will be “securities” under both the Exchange Act and the Securities Act. The SEC has published final temporary rules (the “Rules”) extending temporary exemptions from the Exchange Act and the Securities Act that it previously provided in relation to eligible credit default swaps.<sup>13</sup> The Rules extend, until April 16, 2012 (unless terminated prior to this date because of final rulemaking by the SEC), temporary exemptions under the Securities Act, other than the anti-fraud provisions of Section 17(a), the Exchange Act and the TIA that were first adopted by the SEC in January 2009. The exemptions include Securities Act Rule 239T, which exempts certain credit default swaps from all provisions of the Securities Act that are being or will be issued or cleared by a central counterparty that satisfies certain conditions; Exchange Act Rules 12a-10T and 12h-1(h)T, which exempts eligible credit default swaps that are or have been issued or cleared by a registered or exempt central counterparty from the Sections 12(a) and 12(g) of the Exchange Act in certain circumstances; and TIA Rule 4d-11T, which exempts eligible credit default swaps from having to comply with the provisions of the TIA. The SEC has stated that the purpose of the Rules is to facilitate the continued operation of central counterparties in relation to eligible credit default swaps.

### Temporary Exemptions from Clearing Agency Registration Requirements<sup>14</sup>

The exemptive order issued on July 1, 2011 provides temporary relief to clearing agencies that clear security-based swaps from compliance with Section 17A(b) of the Exchange Act. Section 17A(b) of the Exchange Act requires clearing agencies to register with the SEC and would otherwise apply to all clearing agencies on the Effective Date.

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13 Extension of Temporary Exemptions for Eligible Credit Default Swaps to facilitate Operation of Central Counterparties to Clear and Settle swaps, 76 FR 40223, July 8, 2011.

14 Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions From Clearing Agency Registration.

Requirements Under Section 17A(b) of the Exchange Act for Entities Providing Certain Clearing Services for Security-Based Swaps, 76 FR 39963, July 7, 2011.

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