E-ALERT | Dodd Frank Act

October 20, 2011

CFTC ADOPTS FINAL POSITION LIMIT AND CLEARINGHOUSE RULES IMPLEMENTING DODD-FRANK AND PROPOSES TO FURTHER DELAY EFFECTIVE DATE FOR COMPLIANCE WITH SWAP REGULATION

At an October 18 meeting, the Commodity Futures Trading Commission ("CFTC") approved final rules implementing position limits and core principles for derivatives clearing organizations ("DCOs") under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The CFTC voted 3-2 on each of these final rules, with Commissioners Jill Sommers and Scott O'Malia dissenting. The rules finalize some additional details of the framework for the trading and clearing of swaps under the new Dodd-Frank requirements. The CFTC also proposed to amend its July 14 order regarding the effective date for swap regulation by extending the potential latest period before compliance with certain Dodd-Frank provisions is required from December 31, 2011 to July 16, 2012. The position limit rules relate to agricultural and other non-financial commodities and related swaps, options, and futures, but not to financial product swaps such as interest rate, currency, and credit default swaps. The DCO rules and the proposal to delay the effective dates for compliance with swap regulation apply to all swaps. While the full text of all rules has not yet been published in the *Federal Register*, this alert summarizes some potential implications of the CFTC's new rules.

FINAL POSITION LIMIT RULES

The CFTC first issued proposed rules in January 2010 revising the position limits regime before Dodd-Frank was enacted in July 2010. The CFTC issued a second proposed version of the rules on January 26, 2011. In approving the final rules, the agency moved forward with spot month limits for certain commodities, but will delay implementing the non-spot month limits until it collects data necessary to determine the limit levels.

The CFTC's final position limits regulations impose CFTC-administered limits on speculative positions in 28 core physical commodity contracts and their "economically equivalent" futures, options, and swaps (to which the CFTC refers collectively as "Referenced Contracts").

- Position limits on Referenced Contracts will be set in two phases:
  - *First*, spot-month position limits will be effective 60 days after the CFTC and SEC adopt a final definition of the term "swap." The limits adopted at that time will be based on the spot-month position limit levels currently in place at DCMs. Thereafter, the spot-month limits will be adjusted biennially for agricultural contracts and annually for energy and metal contracts. These subsequent limits will be based on the CFTC's determination of deliverable supply developed in consultation with DCMs.
  - *Second*, the CFTC will set non-spot-month position limits, which are limits applied to positions in all contract months combined or in a single contract month. For the nine "legacy" agricultural Referenced Contracts that currently are subject to CFTC-administered limits, the new non-spot-month limits will go into effect 60 days after the term "swap" is further defined.

These limits will be set equal to the levels described in the final rulemaking. For all other Referenced Contracts (that currently are not subject to CFTC-administered limits), the limits will be made effective by a CFTC order after the CFTC has received one year of open interest data on physical commodity cleared and uncleared swaps under the swaps large trader reporting rule. The non-spot-month limits will be adjusted biennially based on Referenced Contract open interest.

- Spot-month position limit levels will be set generally at 25% of estimated deliverable supply. These spot-month limits will be applied separately for physical-delivery Referenced Contracts and cash-settled Referenced Contracts in the same commodity.
- Cash-settled NYMEX Henry Hub Natural Gas contracts will be subject to a cash-settled, spot-month position limit and an aggregate limit (extending across positions in both physical-delivery and cash-settled natural gas contracts), each set at five times the limit that applies to the physical-delivery NYMEX Henry Hub Natural Gas contract.
- Non-spot-month position limits (i.e., limits applied to positions in all contract months combined or in a single contract month) will be set using the 10/2.5 percent formula: 10% of the contract's first 25,000 open interest and 2.5% thereafter. These limits will be reset biennially based on two years open interest data.
- Open interest used in determining non-spot-month position limits will be the sum of futures open interest, cleared swaps open interest, and uncleared swaps open interest.
- Exemptions for bona fide hedging transactions are provided based on the Dodd-Frank Act's new requirements for such transactions. These exemptions have been broadened to include certain anticipated merchandising transactions, royalties, and service contracts in the final rulemaking to reflect concerns expressed in comments made by commercial firms.
- Exemptions are provided for positions that are established in good faith prior to the effective date of the initial limits established by the regulations.
- The rules establish account aggregation standards consistent with the CFTC's current position limits aggregation policy, including the CFTC's long-standing independent account controller exemption.
- The rules provide for a position visibility reporting regime to assist the CFTC in its surveillance program.
- The rules provide for acceptable practices for DCMs and swap execution facilities for setting position limits for the 28 Referenced Contracts, as well as position limits or accountability rules in all other listed contracts, including excluded commodities.

The much-anticipated final position limit rules were approved after a delayed vote to accommodate a last minute amendment. That amendment concerned the agency's recognition of non-enumerated hedges in the definition of "bona fide" hedge. In dissenting statements, Commissioners Sommers and O'Malia warned that the final position limit rules will make hedging more complex and more costly for end users, and Commissioner O'Malia asserted that the rules' cost-benefit analysis may be susceptible to legal challenge.

FINAL RULES CONCERNING CLEARINGHOUSE CORE PRINCIPLES

The Commodity Exchange Act sets forth core principles with which DCOs must comply to be registered, and to maintain registration, with the CFTC. Dodd-Frank revised and added to these core principles partly to accommodate the new swap clearing function by DCOs. At its October 18 meeting, the CFTC approved final rules implementing these new requirements for DCOs.

In many areas, the rules set out minimum standards for DCOs designed to ensure their safety and soundness, their protection of customer funds, and their ability to comply with various administrative requirements. Specifically, the rules include, among other things, requirements for minimum financial resources, risk management, recordkeeping, and rule enforcement.

Of particular interest to market participants may be the differences in the requirements for DCO treatment of swaps versus futures. In at least two ways, the DCO core principles will require different standards for the different products. First is the core principle governing margin. The final rule will require DCOs to calculate the amount of required margin using different minimum liquidation times for different products. Specifically, a DCO must calculate margin for futures and agricultural, energy, and metals swaps based on a one-day minimum liquidation time, but a DCO must calculate margin for all other swaps (including, among others, interest rate, currency, and credit default swaps) based on a five-day minimum liquidation time. Second, the rules concerning acceptable forms of margin assets will differ among products. Whereas DCOs will be permitted to accept letters of credit as initial margin for futures contracts, letters of credit will not be acceptable margin for swaps contracts. In evaluating the costs of functionally similar futures or swaps contracts, market participants may want to consider these differences.

DODD-FRANK EFFECTIVE DATE

Dodd-Frank generally provides that provisions of its swap regulation framework become effective either (1) on July 16, 2011, or (2) if the provision requires rulemaking before it is implemented, not less than 60 days after publication of final rules.

In July, the CFTC issued an order granting temporary exemptive relief from certain provisions of the Commodity Exchange Act, as amended by Dodd-Frank, that would otherwise have taken effect on July 16. The CFTC's July order provided, among other things, that new Dodd-Frank provisions referencing one or more terms regarding entities or instruments that Dodd-Frank requires be "further defined" -- such as "swap" or "swap dealer" -- will not become effective until either the effective date of final rules further defining the relevant term or December 31, 2011, whichever is earlier.

At its meeting on October 18, the CFTC proposed to amend the July order to extend the final deadline for compliance with new Dodd-Frank provisions from December 31, 2011, to July 16, 2012. The CFTC will accept comments with respect to the proposed amendments to the July order for a short period following the proposal's publication in the *Federal Register*, which has not yet occurred.[1]

If you have any questions about the CFTC's rulemakings or their impact on your business, please contact the following members of our firm:

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[1] By contrast to the CFTC's effective date order issued in July 2011, the SEC's effective date order regarding Dodd-Frank regulation of security-based swaps did not set such a final effective date.

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