

CFTC Issues Final Rules Regarding Registration of Swap Dealers and Major Swap Participants

On January 11, 2012, the U.S. Commodity Futures Trading Commission (the "**CFTC**") approved final rules (the "**Final Rules**") establishing a registration process for swap dealers ("**SDs**") and major swap participants ("**MSPs**" and, together with SDs, "**Swap Entities**"), as required under Sections 4s(a) and 4s(b) of the Commodity Exchange Act (the "**CEA**"), which were inserted by the Dodd-Frank Act.

The Final Rules include a provisional registration process to allow Swap Entities to engage in regulated Swap Entity activities before the formal completion of the registration approval process. The Final Rules also allow phased compliance by Swap Entities with the other requirements of Section 4s of the CEA (the "**Section 4s Requirements**"), which include rules addressing capital and margin, trade reporting, recordkeeping, business conduct and documentation standards and segregation of uncleared swaps margin.

The Final Rules differ slightly from the CFTC's original proposals. A summary of the main changes between the proposals and the Final Rules is set out in the table at the end of this briefing.

Timing of the Registration Requirement

Although the Final Rules will become effective 60 days after publication, a Swap Entity will not be required to register until the date on which the definitions of "swap", "swap dealer" and "major swap participant" ("**Swap Definitions**") become effective (the "**Mandatory Registration Effective Date**"). In addition, Swap Entities will not be required to comply with any Section 4s Requirement until both the Swap Definitions and the relevant Section 4s Implementing Rule become effective. As of the date of this briefing, the CFTC has finalized the Section 4s Implementing Rule regarding business conduct standards, which is subject to a separate client briefing and also finalized certain rules relating to the reporting and recordkeeping obligations of Swap Entities.

Delegation of registration administration to National Futures Association

At the same meeting, the CFTC approved an order delegating authority to the National Futures Association (the "**NFA**") to administer the registration process. The order

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authorizes the NFA to: (i) process and grant provisional registration applications (each, a "**Provisional Application**") and withdrawals from registration of Swap Entities and to notify an applicant of its provisional registration, (ii) confirm initial compliance of a Swap Entity with applicable Section 4s Requirements, (iii) conduct proceedings to deny, condition, suspend, restrict or revoke the registration of any Swap Entity or applicant Swap Entity; and (iv) maintain records regarding Swap Entities.

The delegation by the CFTC of the administration of Swap Entity registrations is broadly consistent with the existing delegation of similar responsibilities to the NFA in relation to other registered activities under the CEA, including, for example, futures commission merchants, introducing brokers and commodity trading advisors. As a consequence of the CFTC's delegation, Swap Entities will be required to become members of the NFA and thereby to submit to the NFA's rules. Swap Entities will, as a result, be required to pay annual membership dues to the NFA. According to estimates by the NFA which are quoted in the commentary to the Final Rules, the annual membership dues "could range between \$125,000-\$1 million per [member] based upon the size and complexity of the firm's swaps business." These membership fees will be on top of a one-off application fee for registering a Swap Entity, which the NFA estimates at \$15,000 per applicant.

Provisional Registration

Provisional Application

Under the Final Rules, a Swap Entity may apply for registration by filing a Provisional Application with the NFA. With effect from the Mandatory Registration Effective Date, only entities that have filed a Provisional Application or that have been finally registered as Swap Entities will be able to engage lawfully in regulated Swap Entity activities. The Final Rules do not provide any guidance as to whether the Provisional Application process will only be available to Swap Entities that submit their applications prior to the Mandatory Registration Effective Date or if it will be available on the ongoing basis.

As is the case with the registration procedure for existing CFTC registration categories, such as futures commission merchants, introducing brokers and commodity trading advisors, a Provisional Application consists of a Form 7-R relating to the applicant firm, with supporting documentation, and, for each principal and associated person of the applicant firm, a Form 8-R along with a fingerprint card.

Form 7-R and related documentation requirements

Form 7-R requires an applicant Swap Entity to disclose the following with respect to the firm:

- name, address and entity type;
- intent to engage in CFTC-regulated swap transactions;
- membership of any U.S. exchanges;
- location of business records (and, with respect to foreign applicants, a US location where records will be available for the CFTC and NFA inspection);
- any non-U.S. financial regulators and self-regulatory organizations that have regulated the applicant in the previous five years;
- criminal, regulatory and disciplinary histories;
- any previous bankruptcy proceedings; and
- contact information.

In addition to a completed Form 7-R, a Swap Entity applying for provisional registration is required to submit documentation demonstrating compliance or the ability to comply with Section 4s Requirements in effect on the date of the Provisional Application. The

The supporting documentation is likely to be voluminous and to require considerable organization and coordination among various internal constituencies at an applicant Swap Entity. Clifford Chance has considerable experience in preparing registration submissions and guiding clients through the application and examination process. Please contact your normal Clifford Chance contact or the authors of this briefing for more information.

supplementary documentation is likely to include organization and personnel charts, financial statements and any financial support arrangements (such as guarantees), internal operations manuals, risk management policies, forms of relevant trading documentation, trading policies and procedures, margin custody and segregation procedures, brokerage, swap data repository, clearing house and out-sourced servicing arrangements, recordkeeping and reporting procedures, chief compliance officer procedures and other written policies and procedures reasonably designed to facilitate compliance with all applicable Section 4s Requirements. An applicant Swap Entity will be required to supplement its initial Provisional Application on an ongoing basis with additional documentation to demonstrate compliance with each rule regarding the Section 4s Requirements ("**Section 4s Implementing Rules**") subsequently finalized by the CFTC.

Form 8-R information for principals and associated persons

Each applicant Swap Entity will be required to disclose the following information on Form 8-R with respect to each of its principals and associated persons:

- name and address;
- criminal, regulatory and disciplinary histories; and
- past residential, employment and education history.

An "associated person of a swap dealer or major swap participant" is any employee of a Swap Entity engaged in the "solicitation or acceptance of swaps... or the supervision of any person or persons so engaged." Under the rules currently applicable to associated persons of existing CFTC registrants, the CFTC treats everyone in the "line of supervisory authority" of an associated person, regardless of seniority, including the president of the firm, as an associated person of a registrant.

The term "principal" is not defined in the CEA, but is defined by the CFTC regulations and the NFA. Based on the NFA guidance for existing CFTC registrants, a principal of a Swap Entity may be either an entity or a natural person. If the current guidance continues to apply, an entity would be a principal of a Swap Entity if it is the Swap Entity's general partner, or if it owns at least 10% of any class of the Swap Entity's securities or has directly contributed at least 10% or more of the Swap Entity's capital. A natural person would be a principal of a Swap Entity depending on the individual's ability to directly or indirectly control the Swap Entity's business activities. Any individual who

- owns at least 10% of the outstanding shares of any class of a Swap Entity's stock,
- is entitled to vote at least 10% of any class of a Swap Entity's voting securities,
- has the power to sell or direct the sale of at least 10% of any class of a registrant's voting securities,
- has contributed at least 10% of a Swap Entity's capital or
- is entitled to receive 10% or more of a Swap Entity's net profits

would be deemed to exercise control over, and be a principal of, such Swap Entity. Similarly, individuals who hold specific positions at a Swap Entity, such as director, president, chief executive officer, chief operating officer and chief financial officer, or who are in charge of the business unit or division that conducts CFTC regulated swaps activity would be deemed principals of the Swap Entity, even if that individual cannot control the Swap Entity's business as a whole.

Provisional Registration Effectiveness and NFA Review Process

A Swap Entity would be deemed provisionally registered immediately upon submission of a Provisional Application.

Upon receipt of a Provisional Application, the NFA will begin a formal review of the Provisional Application and the applicant to determine compliance with applicable Section 4s Requirements. In the course of the review, the NFA may revert to the applicant Swap Entity with comments to the accompanying documentation and request any additional information. It is expected that the NFA will, prior to granting permanent registration, require each provisional registrant to satisfy certain minimum standards for risk

management and compliance systems as well as competence of risk management and compliance staff. Filing a Form 7-R also authorizes the CFTC and the NFA to conduct on-site inspection of an applicant to determine compliance with the applicable rules.

Following the initial submission of a Provisional Application, a Swap Entity will be permitted to engage in regulated swap trading activities during the entire period of the NFA review of such application, unless the NFA notifies the Swap Entity of a deficiency, as discussed below. When the NFA determines that the applicant Swap Entity has demonstrated compliance or the ability to comply with applicable Section 4s Requirements, the provisional registration will be terminated and the Swap Entity will be deemed registered as an SD or MSP, as applicable.

Compliance Deficiencies and Provisional Registration Termination

The Final Rules are ambiguous as to whether a Swap Entity may continue trading while it addresses any deficiencies in its Provisional Application.

The Final Rules permit the NFA to notify any Swap Entity that is subject to provisional registration that its application materials did not adequately cover any aspect of the registration requirements. There is no limit on the number of such deficiency notices that the NFA may deliver to a Swap Entity prior to approving its final registration, and the NFA is not required to wait until it has completed its review and identified all of the deficiencies before delivering a notice with respect to a specific deficiency.

The finalized wording of CFTC Regulation 3.10(a)(1)(v)(D)(1) sets out three automatic consequences if the NFA notifies a Swap Entity that its application is deficient:

- The Swap Entity must withdraw its application for registration;
- The Swap Entity must not engage in any new activity as a swap dealer or major swap participant; and
- The Swap Entity shall cease to be provisionally registered.

A proviso to the regulation then states that if the Swap Entity does not withdraw its application or cure the deficiency within 90 days of receipt of the notice (or such longer period as the CFTC or the NFA may decide), the application will be deemed to have been withdrawn and the Swap Entity's provisional registration shall cease. While the drafting is inelegant, it seems clear that the intention is to provide a 90-day cure period to mitigate the otherwise immediate effect of the Swap Entity's obligation to withdraw its application and the termination of its provisional registration.

However, neither the proviso, nor the CFTC staff's commentary on the rule, make any mention of the prohibition on new activity by the Swap Entity. It may be that the staff did not consider that the prohibition needed to be specifically mentioned in the proviso, because as long as a Swap Entity is provisionally registered, it is authorized to do everything that a registered entity may do. On the other hand, the same logic would imply that the Final Rule did not specifically need to include the prohibition on new activity, because any entity that is not properly registered (whether provisionally or finally) may not lawfully engage in any activity that requires registration.

The better interpretation is most likely that, during the cure period, the Swap Entity may continue to trade swaps and otherwise continue its business as a registered entity. The lack of clarity on such an important feature of the provisional registration process is concerning, and market participants should encourage the CFTC staff to clarify this provision as soon as possible.¹

It is to be expected that any Swap Entity operating with provisional registration will be required to comply with all applicable Section 4s Requirements as a matter of course, in the same way as permanently registered entities. Compliance failures may result in CFTC enforcement action.

No Statutory Disqualification of Associated Persons and Principals

Although an associated person is required to file a Form 8-R, neither the CEA nor the Final Rules require associated persons of Swap Entities to register with the CFTC. This is different from most other CFTC registrants, such as commodity trading advisors and futures commission merchants. Nevertheless, under the Final Rules a Swap Entity may not permit any individual associated person who is a natural person "to effect or be involved in effecting swaps" on behalf of the Swap Entity if they are subject to a statutory disqualification under the CEA.

A person would be subject to a statutory disqualification if they (i) have been refused registration within five years preceding the filing of the Provisional Application, or had their registration suspended (and the period of such suspension has not expired), or revoked; (ii) are permanently or temporarily enjoined by a court or regulatory order from acting in any registered capacity under the CEA or securities regulation; (iii) have been convicted of any felony that involves embezzlement, fraud, theft, bribery or misappropriation of funds in connection with any commodities or securities transactions within ten years preceding the filing of the Provisional Application or at any time thereafter; or (iv) have violated (or aided and abetted in violation of) any provision of the CEA or certain other US federal statutes, where such violation involves embezzlement, fraud, theft, bribery or misappropriation of funds.

Each Swap Entity will be responsible for ensuring that none of its associated persons is subject to a statutory disqualification and will be required to certify to this effect in the Form 7-R. Similarly, the NFA may deny registration to a Swap Entity if any of its principals is subject to a statutory disqualification. The Final Rules do not limit the prohibition on employing associated persons subject to a statutory disqualification to US residents or US Swap Entities.

¹ The wording of the regulation is:

"Where an applicant for registration as a swap dealer or major swap participant to whom the National Futures Association has provided notice of provisional registration under § 3.2(c)(3) fails to demonstrate compliance with a Section 4s Implementing Regulation, the National Futures Association will notify the applicant that its application is deficient, whereupon the applicant must withdraw its registration application, it must not engage in any new activity as a swap dealer or major swap participant, as the case may be, and the applicant shall cease to be provisionally registered; Provided, that in the event the applicant fails to withdraw its registration application or cure the deficiency within 90 days following receipt of notice from the National Futures Association that its application is deficient, the application will be deemed withdrawn and thereupon its provisional registration shall cease; Provided further, that upon written request by the applicant submitted to the Commission, the Commission may in its discretion extend the time by which the applicant must cure the deficiency."

Summary of Changes between Proposed and Final Rules

Issue	Proposed	As Adopted
Definition of "associated persons"	The Commission requested comment on whether the definition of "associated persons" in relation to swaps entities should be restricted to natural persons.	Adopted. CFTC Regulation 1.3aa has been amended to limit the definition of "associated person" only to natural persons associated with a Swap Entity in a capacity that involves the solicitation or acceptance of swaps, or the supervision of persons so engaged.
Statutory Disqualification	The Commission proposed that an SD or MSP would be responsible for ensuring that its associated persons are not subject to a statutory disqualification.	Adopted as CFTC Regulation 23.22(b). Final Rule also adopts the NFA-proposed exception from statutory disqualification requirement with respect to any person who is already listed with the NFA as a principal or registered with the CFTC as an associated person of another registrant, a floor broker or a floor trader.
Provisional Registration	The proposed regulation provided for notification of provisional registration "pending completion of a fitness review by the National Futures Association".	The Final Rule provides that provisional registration is effective upon initial submission of an application for provisional registration to the NFA, rather than upon completion of the NFA application review process.
Compliance with Section 4s Implementing Regulations in effect at the time of application	In the proposal the Commission had requested comments on the coordination of the registration process with the implementation of the Section 4s Implementing Regulations.	The Final Rule provides for phased compliance with Section 4s Requirements as Section 4s Implementing Regulations become effective.
Cure period for deficiencies in application for registration	The CFTC had proposed a 30-day cure period, subject to extension at the discretion of the CFTC.	The Final Rule adopted a 90-day cure period, subject to extension.
Responsibility for determining initial and ongoing compliance by Swaps Entities	In its proposals the CFTC suggested three alternatives: no delegation to any person, full delegation to the NFA (or any subsequently registered futures association) and partial delegation to the NFA.	The CFTC has delegated full registration authority under the CEA and the CFTC Regulations to the NFA with respect to Swap Entity registration
Costs of SD and MSP Registration Regulations	The CFTC had estimated \$500 for the registration fee in the proposal.	Based on current estimates from the NFA, the CFTC believes registration fees will be approximately \$15,000 per registration application, and the NFA membership dues will range from approximately \$125,000 to \$1 million per year, depending on the size and complexity of the Swap Entity's swaps business.

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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