

FS Regulatory Brief

The Tipping Point: Swap Product Definitions Finalized

July 2012

Last week, the Commodity Futures Trading Commission and Securities and Exchange Commission released final definitions of what is a “swap” or “security-based swap” (SBS) under the Dodd-Frank Act. This release serves three major purposes for Title VII watchers. It:

- Defines which instruments are regulated as swaps or SBS, but more importantly,
- Sets the deadlines for compliance with many CFTC Title VII regulations, and
- Starts the SEC sequence for finalizing rules regarding SBS.

While the content of the product definitions rule is important and of interest, this ***FS Regulatory Brief*** discusses the projected timing for swap dealers (and major swap participants) to comply with major segments of the CFTC’s regulation of swaps. ***It includes an estimated timeline to help US and foreign swap dealers with tracking priorities for action.*** It also describes the proposed sequence that the SEC plans to follow to roll-out its regulations of SBS markets. We will address the new parameters for identifying a swap or SBS separately.

The Tipping Point

Aside from the clarity the release offers regarding the jurisdictional lines drawn around derivatives products, this rule brings the regulation of swap markets by the CFTC to the tipping point from watching and planning to compliance and deadlines. Many CFTC final rules set compliance dates based on the date that the final product definition appears in the Federal Register. For example, US swap dealers will have compliance dates for the following major rules set 60 days after the Federal Register publication of the product rules:

- Registration
- Risk Management
- Business Continuity/Disaster Recovery
- Recordkeeping
- Conflicts of Interest
- Real Time Reporting for SDs engaged in IRS and Credit Swaps
- Confidential Regulatory Reporting for SDs engaged in IRS and Credit Swaps
- Historical Swap Reporting by SDs with IRS and Credit Swaps

We expect these deadlines to fall in October or, for some rules, by year-end, if the CFTC’s proposed Cross-Border Guidance and temporary exemption proposals become final. Foreign swap dealers will have to meet the same deadlines as US swap dealers unless they operate in jurisdictions where, for some of these rule areas, substituted compliance is permitted under Cross-Border release.

Start the countdown

The official countdown to many compliance deadlines will start when the final Product Definitions rule, which was released this weekend in draft form, appears in the Federal Register. In the past this has taken between two to six weeks.

Assuming the final product definition rule is published in the Federal Register on or around August 1, 2012, swap dealer registration for US and foreign swap dealers would be required on or about October 1, 2012. Compliance dates for other rules would follow very quickly thereafter – compliance with external business conduct rules, for example, is required by the registration date or October 15, whichever is later.

We provide a more detailed timeline of projected deadlines in the key Title VII areas below.

Other takeaways

Although the CFTC Chairman didn't discuss these points in great detail or with much specificity, he made the following observations in his opening remarks on the final definitions:

- CFTC staff are preparing rules regarding swap relationship documentation and confirmations and will “shortly” provide them to the Commissioners for final consideration
- Commissioners are currently reviewing staff recommendations on mandatory clearing determinations and the Chairman expects them to be released for public comment “later this month.” Publication of the initial determination triggers a 90-day process meaning that, in the Chairman's view, the first final determinations on what swaps will be required to be cleared could come in October.

SEC rulemaking sequence begins

In the context of SEC SBS rulemaking efforts, this rule is the first in an announced sequence that the agency plans to follow to finalize the many draft rules it has published on SBS. The SEC's phased approach to regulating the SBS markets addresses five categories of rules:

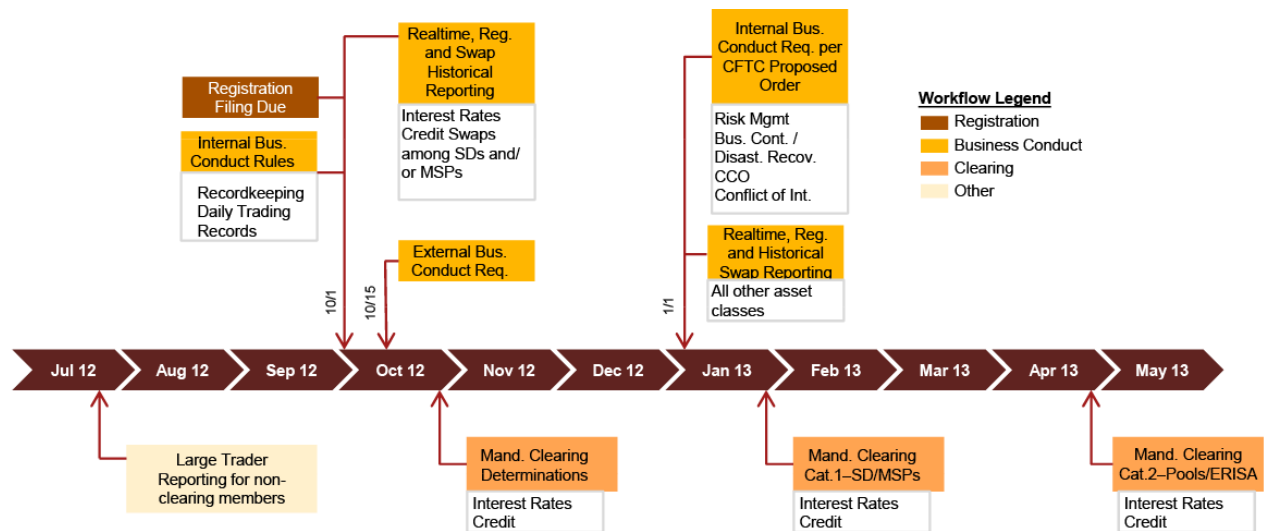
1. Product and Entity Definitions (“Definitional Rules”) and Cross-Border Rules
2. SBS Data Reporting
3. SBS Clearing and Exemptions
4. Entity Registration
5. SBS Trading on Exchanges and SEFs

Note that capital and margin requirements were left off this list. The SEC plans to issue rules in roughly this sequence. We will explore the implications of the SEC's roll-out of Title VII regulation of SBS in a separate FS Regulatory Brief.

Action required

The appearance of the final product definition rules confirms the need for US and foreign swap dealers, and MSPs, to continue to build toward compliance, particularly with respect to registration, swap data reporting and recordkeeping and enhanced business conduct infrastructure. Although the projected deadlines may slip, they are not expected to slip much. It is also not clear whether the CFTC plans to issue exemptive relief across the industry on any further topic, such as the operationally challenging external business conduct rules. Banks may wish to revalidate their workstream priorities to ensure alignment with the projected deadlines. Those with significant, expected challenges in meeting these ambitious targets may also want to develop a strategy for approaching the regulators on exemptive relief or further guidance.

Timeline 1. US Swap Dealers (Prudentially Regulated) Trading Swaps with US or Foreign Persons in the United States: Projected CFTC Compliance Deadlines¹

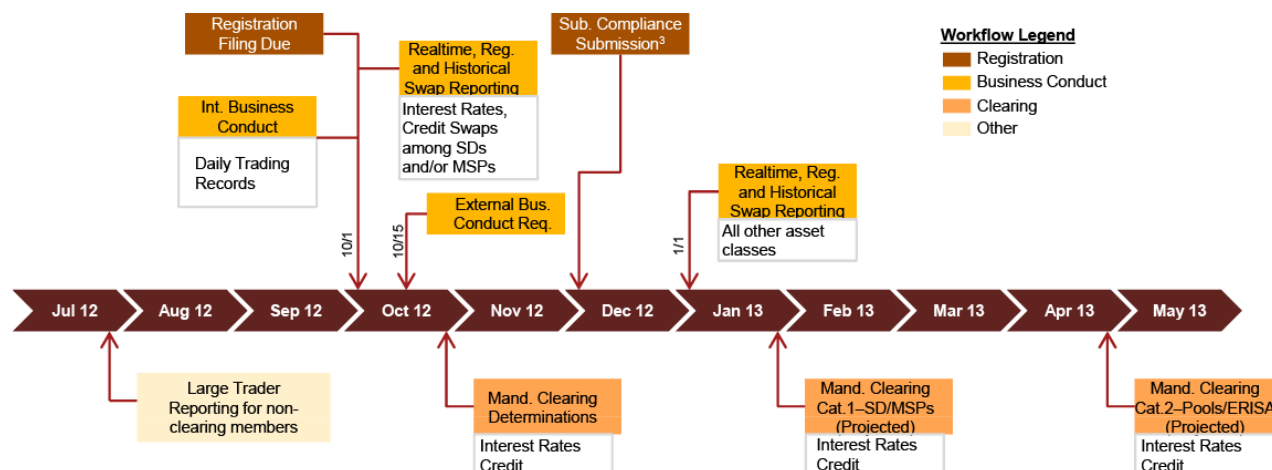


Timeline 1 represents timing for major rule sets applicable to prudentially regulated US swap dealers *acting as swap dealers*. This does not show deadlines applicable to FCMs or to clearing members of a derivatives clearing organization (e.g., LSOC, Lg. Trader Reporting, Clearing Member Risk). Foreign branches of US swap dealers may be eligible for delays when trading with non-US persons on the same basis as foreign swap dealers. See Timeline 2.

For the following *proposed* CFTC rules, compliance dates are highly speculative and not on this timeline:

- Capital and Margin for Uncleared Swaps (publication est. Q3-Q4 2012)
- Swap Trading Relationship (and Related) Documentation (publication est. Q3 2012)
- Portfolio Reconciliation and Compression (publication est. Q3 – Q4 2012)
- SEF final rules and Trade Execution Mandate (Q4 2012)

Timeline 2. Foreign Swap Dealers Trading Swaps with US Persons: Projected CFTC Compliance Deadlines²



² Timeline No. 2 reflects application of CFTC rules to foreign swap dealers trading swaps with US person counterparties (and equivalents) that qualify for substituted compliance delays.

³ Upon a showing of comparable home country regulation, substituted compliance would give foreign swap dealers up to a one year delay for compliance with (a) Entity Level requirements re: risk management, business continuity/disaster recovery, swap data recordkeeping and chief compliance officer and (b) certain Transaction Level requirements for swaps with non-US persons. Daily trading records rules, some Large Trader Reporting, and many Transaction Level requirements would apply for all swaps with US counterparties other than non-US branches of US swap dealers and their equivalents. For details, see PwC FS Regulatory Brief, “Extraterritorial Derivatives Guidance Proposed by CFTC: More Analysis Required, Impact Unclear” (July 2012).

Additional information

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