Clients&FriendsMemo

Two Dodd-Frank Problems: the Effective Date and the Definitions
Contingency Planning in the Absence of a Regulatory Structure

June 13, 2011

This memorandum first explains the July 16, 2011 problem that will arise because the Dodd-Frank derivatives legislation (Title VII of the statute) goes into effect without either a ready regulatory plan or an operating market structure. The effective date problem is made worse because of drafting problems in Dodd-Frank, including the flawed definition of the single most important term in all of the statute: "swap."

The effective date problems will not be resolved on July 16, 2011. July 16, 2012 will bring another set of problems due to a deadline that cannot be achieved and should not be targeted.

The final part of the memorandum recommends that all market participants, in fact, all participants in the economy, contingency plan as to how to conduct their business in the absence of a workable regulatory structure. At best, we will be operating, from July 16, under a law that is far from being implemented, if it can be implemented at all, on the basis of likely-incomplete regulatory exemptions the effectiveness of which depends on statutory language that is itself uncertain.[1]

I. July 16, 2011

On July 16, 2011, Section 731(a) of Dodd-Frank makes it illegal for an entity to act as a swaps dealer unless registered with the Commodity Futures Trading Commission (the "**CFTC**"). On July 16, 2011, Section 764(a) of Dodd-Frank similarly makes it illegal to act as a security-based swaps dealer unless registered with the Securities and Exchange Commission (the "**SEC**"). There is currently no means to register available with either the CFTC or the SEC (the "**Commissions**"),

[1] The SEC has recently issued its first proposed effective date exemption – but it is limited to security-based swaps issued by certain clearing agencies. Hopefully more and broader exemptions will quickly follow.

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nor is there any body of rules that would apply to a dealer that could register, nor even a set of proposed rules that is near-ready.[2]

On July 16, 2011, Section 723 of Dodd-Frank makes it illegal for a person or entity that does not qualify as an "eligible contract participant" ("**ECP**") to enter into a swap, other than one executed on an exchange that trades swaps. Section 763 of Dodd-Frank contains a somewhat parallel provision, making it illegal for anyone to execute a security-based swap for any non-ECP other than on an exchange that trades security-based swaps. There are no such swap exchanges, nor will there be by July 16, and therefore the exceptions to the prohibitions will be unavailable on July 16.

On July 16, 2011, Section 731 and 761 of Dodd-Frank require that any swap dealer that acts as an "advisor" to a "Special Entity" (essentially a municipality, pension plan or endowment) shall have a duty to act in the "best interests" of the Special Entity. The term "advisor" is not defined, but it is generally feared that the regulators will expand the term beyond its plain English meaning. Further, it is not that clear how a swap dealer, which trades with a Special Entity and is also deemed to be an advisor to the Special Entity, can act in the Special Entity's best interest – since the two parties are on *opposite sides* of a trade, and therefore any price that the swap dealer charges above zero may not be in the Special Entity's "best interest." In short, as of July 16, 2011, there will be legal uncertainty in any swap dealer communicating with Special Entities with which it trades lest it be deemed an advisor.

When Congress adopted Dodd-Frank with an effective date of July 16, it also as of that date terminated significant parts of the Commodity Futures Modernization Act (the "**CFMA**"), which provided the legal framework under which the swaps market had previously operated, and which had given legal certainty to the enforceability of swaps contracts. Likewise, Dodd-Frank, as of the same date, terminates provisions of the CEA that had protected swaps from legal attack under state law by either state regulators or private litigants.[3]

A. The Mechanics of Effectiveness of Dodd-Frank

Section 754 of Dodd-Frank provides that the provisions of Title VII (essentially the derivatives portion of Dodd-Frank) become effective (i) in the case of provisions that do not require rulemaking,

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[2] The CFTC has published a significant number of rule proposals, while the SEC has published fewer. However, the gap between the CFTC and the SEC output is narrower than it appears because a material number of the CFTC's rule proposals require, at least in my view, substantial revision.

[3] *See* Dodd-Frank Act, Title VII, Section 723(a)(1)(2) (repealing CEA Section 2(g), the statutory exclusion for swap transactions enacted by the CFMA, and CEA *and* CEA Section 12(e)(2)(B), as amended by the Dodd-Frank Act (deleting reference to Section 2(g) from provision preempting application of state laws on gaming and on bucket shops).

July 16, 2011[4] and (ii) in the case of provisions that do require rulemaking, not less than sixty days after the rulemaking becomes effective.

Neither Section 731 nor Section 764 (which make it illegal to act as an unregistered swaps dealer) require by their terms a rulemaking – they are simply prohibitions.[5] Similarly, neither Section 723 nor Section 763 (which make it illegal to enter into swaps with a non-ECP) require a rulemaking – they, too, are simply prohibitions. Section 721 of Dodd-Frank (the definition of a "swap"), likewise, does not require a rulemaking. Thus, these provisions become immediately effective. Likewise, the provisions of Dodd-Frank that eliminate the CFMA and the protection from attack under state law also become effective on July 16.

B. The Statutory Definition of the Term "Swap" and How That Worsens the Effective Date Problem

The Dodd-Frank definition of "swap" (Section 721) sets out a number of types of contracts that are either "included within" or "excluded from" the scope of that term. The broadest (and thus most problematic) of the "included within" prongs is to the effect that the term "swap" includes any contract that has any purchase, sale, ***payment, or delivery [obligation or amount]***[6] that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event with a potential financial, economic, or commercial consequence.

This inclusive prong of the definition is too broad: it can include by its literal terms, as the Commissions have recognized, transactions such as the following (assuming that there is some element of payment or delivery contingency to the contract):[7]

- agreements to acquire or lease personal property
- agreements to obtain a mortgage
- agreements to provide personal services
- agreements to assign rights, such as intellectual property rights

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[4] Under the words of the statute, Dodd-Frank is to become effective 360 days after its adoption. As Dodd-Frank was adopted on July 21, 2010, the 360-day delay between adoption and effectiveness sets the effective date as July 16, 2011.

[5] Hopefully, the Commissions will adopt the view that these prohibitions implicitly do require a rulemaking; *i.e.*, a registration procedure, and thus they are ineffective until at least sixty days after a registration procedure is available. Be aware, however, that not all of the provisions of Dodd-Frank that apply to swaps dealers are limited to those that are registered, or even to those that are required to be registered (although some of this too may be loose drafting).

[6] Emphasis supplied. (Not an exact quote. I added the words "obligation or amount" added for clarity.)

[7] *See* 76 Fed. Reg. 29818 (May 23, 2011) (the "Swap Definition Release").

- agreements to purchase home heating oil (if the contract has a cap in it)
- agreements that have any interest rate cap or lock
- consumer loans with variable rates of interest
- mortgage loans with various rates of interest
- employment contracts
- retirement benefit arrangements
- sales arrangements
- merger agreements
- warehouse lending agreements
- any loan with a variable rate of interest made by a nonbank
- leases
- service contracts
- certain employment agreements
- insurance contracts[8]

In short, the literal words of Dodd-Frank seem to define as "swaps" a substantial portion of all contracts entered into in the United States. Whether this is ¼ or ½ or ¾ by value of contracts, I cannot say. But is large enough to be meaningful to the general U.S. (and global) economy, not just on Wall Street.

The problem of this broad definition is compounded by the fact that any of these contracts is illegal, as of July 16, 2011, if (i) entered into by a non-ECP or (ii) by an unregistered swaps dealer. We

[8] One of the really interesting questions as to the grant of power to the Commissions arises with respect to the definition of the term "insurance." Historically, the U.S. federal government has deferred to the individual states as to the regulation of insurance. *See generally the McCarran-Ferguson Act, 15 U.S.C. Section 1011-1015*. However, given the broad definition of the term "swap," the Commissions are effectively delegated the power to define what constitutes insurance (*i.e.*, what is not a "swap") within the meaning of McCarran-Ferguson. The types of state-regulated insurance contracts that will be permitted by the Commissions are described at pages 29821-27 of the Swaps Definition Release. *But see also page 29822* (the Commissions express concern that the offering of state-regulated insurance contracts could be used as a means "to evade the[ir] regulatory regime" under Dodd-Frank, such that the Commissions will prescribe what fits within the definition of the term insurance).

have also noted that there are likely to be additional risks, even if not outright illegality, attached to swaps with so-called "Special Entities."[9]

C. Some Limited Solutions to the Effective Date and Definitional Problems

1. The Rulemaking Solution to the Swap Definition Problem?

In order to address the problem of the breadth of the definition of the term "swap," the Commissions have proposed in the Swap Definition Release to exclude by rule many of the contracts listed above from the definition of the term "swap," ***albeit subject to conditions***. For example, under the Commissions' proposed rule, a capped agreement to purchase home heating oil would not be a swap *provided* it were entered into by a "natural person . . . primarily for personal, family or household purposes. . . ."

This leaves open the question of whether a home heating oil contract could be a "swap" if entered into for other purposes (for example, to purchase gas for a rental unit owned by a natural person as a business) or if the heating contract were entered into through a personal trust. The Commissions' response to this question and numerous other uncertainties, in the Swap Definition Release, is that "the Commissions invite . . . [anyone having definitional questions] to seek an interpretation" – but this seems likely to be a slow process given the volume of questions that could arise and the required procedures for answering them.[10]

In the Swap Definition Release, the Commissions do not attempt to tie their proposed limitation of the definition of the term "swap" to the actual statutory language of Dodd-Frank or to its legislative history (of which there is not much substantive; most of the legislative history is just earlier versions of the final bill, and these versions do not provide guidance as to the intended meaning of the term "swap"). Rather, the Commissions merely state that they "do not believe that Congress intended to include" these types of transactions within the "swap" definition.

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[9] I also note that the term "swap" is not the only defined term in Dodd-Frank with which there are serious problems-although it is obviously significant that the single most important defined term in the entire statute cannot possibly mean what it says. For example, the term "Special Entity" is defined (at Section 731) to include "endowments," but the term endowment is not itself defined.

[10] In the Swap Definition Release (at 29864), the Commissions caution that "***any*** [emphasis supplied] interpretation of, or guidance by," either of the Commissions, with respect to the derivatives legislation, is only effective if the two Commissions "***issue joint regulations***" [emphasis supplied] "***after consultation***" [emphasis supplied] with the Federal Reserve Board.

As a practical matter, it could seldom be less than six months, and one would think realistically a longer time, to obtain a joint rulemaking from two major federal agencies, after consultation with a third. This leaves open the question of whether it would even be possible to obtain the attention of the agencies, given the backlog of Dodd-Frank rulemaking, never mind other duties of the Commissions.

This somewhat loose tie between (i) the statutory definition in Section 721 of the term "swap, on the one hand, and (ii) the Swap Definition Release, on the other, emphasizes an important, and somewhat overlooked, legal question as to whether the Commissions even have the authority, which is assumed by the Swap Definition Release, to limit the scope of the term swap. Section 721(c) of Dodd-Frank provides that the CFTC can ***include*** transactions within the definition of the term "swap" to the extent that such transactions have been structured to ***evade*** Dodd-Frank. This would seem to imply that the Commissions can ***expand the definition*** of swap even further (not that such expansion is needed), but do not have legal authority to shrink it. That the Commissions do not have authority to limit the scope of the swap definition is further evidenced by Section 772 of Dodd-Frank, which amends Section 36 of the Exchange Act to limit the SEC's authority to provide any exemptions with respect to the definition of the term "swap."[11] That the Commissions do not have the authority to limit the scope of the term "swap" might also be argued by comparing the authority that the Commissions are given with respect to other defined terms. For example, the CFTC is given authority to "include within, or exclude from" the term commodity pool operator. But this authority is not provided to the Commissions acting either alone or jointly with respect to swaps, which would seem to imply that the authority to limit the definition was not intended.

Section 712(d) of Dodd-Frank does give the Commissions, subject to various procedural and consultation requirements, various kinds of regulatory authority to adopt rules with respect to the definitions, including to **"further define"** the term swap. It is certainly not clear that this gives the Commissions' plenary authority to limit the definition of the term swap, so as to effectively provide exemptions, as this seems inconsistent with the plain words of Sections 721 and 772. That said, the Commissions, as a practical matter, ***must ignore this problem of their authority***. That is, in order to have any hope of making the statute workable, they must effectively expand their exemptive authority under Section 712(d) (and ignore the limitations on their authority under 721 and 772), which is exactly what they do in the Swap Definition Release. Although I agree that they had no choice but to proceed in this way, it would be better if the Swaps Definition Release stood on firmer legal ground.[12]

Assuming the Commissions have authority to limit the statutory definition of the term "swap," even if the Commissions' proposed rule were to be adopted yesterday, given a 60-day waiting period, the proposed rule would not be effective before July 16. This delay in limiting of the definition of the term "swap" may create more uncertainty.

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[11] Section 721 of Dodd-Frank appears to similarly expressly limit the power of the CFTC to provide exemptions with respect to the definition of the term "swap". We say "appears" because the key verbs were actually omitted from the relevant provision of Section 721, leaving only a very long and garbled sentence fragment.

[12] Ultimately, the best argument for the Commissions' expensive definitional authority is probably just common sense: the definition of the term "swap" can't possibly be read at its literal meaning.

2. The "Common Sense" Solution to the Swap Definition Problem?

One possible "solution" to the legal uncertainty problem created by the Dodd-Frank definition of "swap" is to pretend that it does not exist; in other words, to pretend that we all know "by common sense" what a "swap" is, and that it does not really matter what the words of Dodd-Frank say or whether the Commissions have adopted a rule to limit the statutory definition, or whether the Commissions even have the authority to adopt such a rule.

There are at least two problems with this approach.

The Common-Sense Problem. First, there is a point at which our respective understandings of "common sense" must diverge. For example, I would have said that, as a matter of common sense, Congress could not have intended either to regulate the sale of loan participations between banks as swaps or to treat the purchase of a capped contract on home heating oil as a swap. However, the Commissions seem to disagree, at least as to those contracts that do not meet the conditions imposed in the Swap Definition Release. And of course, there will be other instances where my common sense tells me that I am in a gray area, and I may not want to take the chance of entering into an illegal transaction.

The Law School Exam Problem; Also the Private Litigant Problem. The second problem is in the places where there is risk in spite of our common sense agreement. For example, suppose that a bank offers a floating-rate home mortgage to a young couple with children. We all may agree that – by common sense – a floating rate home mortgage is not a "swap." Suppose, for purposes of our law school exam example, the home mortgage is affordable given the couple's current income and current interest rates. Now, a lawyer for the bank is called upon to give a legal opinion that the floating rate mortgage is valid and binding; *e.g.*, the mortgage is not a "swap" within the meaning of Dodd-Frank, notwithstanding that the payments required on the mortgage will vary with events of economic consequences; *i.e.*, changes in interest rates.

What is the correct answer to the law school exam question: should the lawyer (i) opine that the mortgage is valid and binding, based on common sense, or (ii) express no view as to the treatment of the mortgage as a swap under Dodd-Frank?

Suppose that the bank goes ahead and makes the loan, perhaps based on the flat opinion of the lawyer. After three years, one of the couple is unemployed and interest rates have risen, so that the couple is unable to make the now-higher payments on the floating rate mortgage. The bank tries to foreclose on the loan. The lawyer for the couple asserts that the floating rate mortgage cannot be enforced because, under the literal language of Dodd-Frank, the mortgage is an illegal swap.

What does the judge do? Does the judge enforce the foreclosure of the bank, notwithstanding the literal language of Dodd-Frank? If the judge rules in favor of the couple, can the bank sue the lawyer for malpractice?

These law school exam questions are intended to demonstrate that the effective date and definitional problems of Dodd-Frank cannot be solved entirely by assuming the common sense and restraint of federal regulators. One must also be concerned with the independent actions of private litigants, as well as the actions of state government authorities.

3. The "Announcement" Solution to the Problem

CFTC Chairman Gensler was recently quoted in the newspapers as saying that July 16 "would not be an event at all for market participants."[13] He went on to say, "We will have "announceables." There will be documents on our website. . . before July 16."

While Chairman Gensler's statement is obviously good news, it also raises legal questions. That is, on the one hand, Dodd-Frank is a statute, adopted by Congress, which, by its literal terms, seems to regulate a good portion of all the transactions in the entire U.S. economy as of July 16. On the other hand, a regulator, in fact a single regulator, is able to promise to make the statute "not . . . an event." Further, even if the Chairman was speaking for the CFTC or for all of the relevant regulatory organizations, there must be a limit as to what the regulators can do without Congress.[14]

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[13] Jamila Trindle, *Regulators to Give More Guidance on Dodd-Frank Law before July Deadline*, Reuters (June 2, 2011), available at http://www.nasdaq.com/aspx/stock-market-news-story-aspx?storyid=201106021601dowjonesdjonline000637&title=regulators-to-give-more-guidance-on-Dodd-Frank-law-before-july-deadline.

Another story quoted Chairman Gensler as saying, "We have ample latitude within the statute to address any July 16 issues as I know about them." Jonathan Spicer, *CFTC aims for certainty over July 16 rule deadline*, Reuters (June 2, 2011), *available at* http://www.reuters.com/article/2011/06/02/financial-regulation-cftc-idUSN0228261220110602.

It is not entirely clear from which parts of Dodd-Frank the latitude to which Chairman Gensler refers arises. It is likewise not clear what to make of the statement that issues could be solved if he would "know about them." That is, without a public proposal of the required exemptive rules, there is not an opportunity to give input as to whether in fact all issues are resolved.

[14] It appears that the Chairman has been joined by at least one other CFTC Commissioner in expressing confidence that the fundamental questions relating to the statutory deadline can, in effect, be voided by administrative action. *See* Huw Jones, *Traders to get "safe harbors" on some rules*, Reuters (June 7, 2011), available at http://www.reuters.com/article/2011/06/07/us-cftc-omalia-idUSTRE7563CL20110607 (quoting CFTC Commissioner Scott O'Malia as stating that the CFTC is "working on a document and a proposal right now that creates certain safe harbors for self executing rules, to delay them until the new rules are in place. . . [and that] [w]e are going to provide some temporary safe harbor until the underlying rule or definition is provided. . . So all of this will hopefully be clear in a week or two.").

D. Further Trouble on the Horizon

The problems with the implementation of Dodd-Frank are not simply July 16, 2011 problems. Suppose that the regulators will be, by July 16, 2011, halfway to their required task of building a new regulatory system. This means that, all during the coming year, as the regulators are adopting new rules, swap dealers (who are primarily banks) will be attempting to build systems and procedures to comply with the new rules (which will be challenging to accomplish).

On July 16, 2012, Section 716 of Dodd-Frank (more commonly known as the Lincoln Amendment) goes into effect. Under this provision of Dodd-Frank, U.S. branches of non-U.S. banks can generally no longer act as swaps dealers. Thus, all of these branches that have spent the year attempting to build a system to come into compliance with Dodd-Frank will now have to move their swap dealer business to a different legal entity. Even assuming that the regulatory system is by then completed, this will prove a material operational strain on these non-U.S. banks.

As a practical matter, the problem gets worse. Section 716 materially discriminates against U.S. branches of non-U.S. banks as compared to U.S. banks. That is, U.S. banks in the United States are provided exemptions not available to non-U.S. banks in the United States. This discrimination has ***no policy basis whatever***; it was a mistake that was supposed to be corrected in a post-Dodd-Frank amendment, but never was.[15] Can this prohibition against non-U.S. banks can go into effect without non-U.S. governments considering actions to level the playing field, either by imposing similar disadvantages on U.S. banks operating abroad or acting against other U.S. corporations?

There will be more deadlines to come. In the two-year period after July 16, 2012, portions of Lincoln will gradually come into effect even against U.S. banks. These banks too will then have the practical problem of meeting the deadline for moving their swaps dealer business to another legal entity.

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[15] In light of the various inconsistencies in the treatment of U.S. branches of U.S. banks and U.S branches of non-U.S. banks by the Lincoln Amendment, after the Conference Committee voted out the bill, but before full Senate approval, on July 15, 2010, Senator Lincoln made a statement on the floor of the Senate, stating that it was not the intent of the Senate to exclude U.S. branches of foreign banks from the exemptions and safe harbors provided to U.S. banks, and that they should be treated under the Lincoln Amendment in the same fashion as U.S. branches of U.S. banks. At the same time, Senator Dodd indicated that this would likely be addressed on a technical corrections bill. ***No such technical corrections bill has ever been introduced in the Senate***. Thus, in the absence of a correction, U.S. branches of foreign banks would effectively be barred from serving as swap dealers from July 16, 2012. For additional information, please refer to Cadwalader's Clients & Friends Memo, *The Lincoln Amendment: Banks, Swap Dealers, National Treatment, and the Future of the Amendment* (December 14, 2010), http://www.cadwalader.com/assets/client_friend/121410FutureoftheLincolnAmendment.pdf.

II. Why Dodd-Frank Could Never Have Been Ready: Just Too Big

Various legal observers have published "fun facts" about Dodd-Frank; *e.g.*, as to the number of rules that Dodd-Frank requires to be implemented, the number of studies to be made and, lately, as to the number of deadlines missed by the regulators. Although these numbers seem to illustrate the problem, they in fact diminish the scope of the task, as if we were counting hiking Mount Everest as taking one of 453 bumps in the road.

A. Too Many Rules

By way of example, let's take the need for the regulators to establish rules for the regulation of swaps exchanges. Let's suppose that there is a need for five CFTC and five SEC rules under Dodd-Frank relating to the establishment of such exchanges. At one point, the CFTC was estimating that there might be 50 such exchanges under its authority alone. To keep the numbers simple, suppose that there might be 100 such exchanges, 50 under the authority of the CFTC and 50 under the authority of the SEC. Each such exchange will need its own set of rules: let's say 100 rules per exchange. This bring us from our original ten rules that must be written to 10,010 (although the 10,000 need not be written by the SEC and the CFTC).

But this again diminishes the problem by reducing it to mere numbers.

B. Too Much Infrastructure

None of these swap exchanges exist. How are the communications and operations systems for all these exchanges to be built within a reasonable timeframe, so that links between them and the dealers and the customers can be created? And that is to say nothing of the other operating structures assumed by Dodd-Frank: clearing corporations, swaps data repositories, major swap participants.

The problem of scaling Mount Everest is not just that we have gone from 453 to 10,010 bumps in the road. At least Mount Everest is already standing; all we have to do is walk over the bump. Dodd-Frank requires construction.

C. Too Much Legal Staffing

I do not know how much staff the regulators thought they would need to implement Dodd-Frank, but whatever was estimated, it was likely too small. If we would have 100 newly created exchanges, along with clearing corporations, swap data repositories, newly regulated dealers, swap

participants, additional regulated investment funds, and many dually- and triply-registered entities,[16] along with staffs to regulate all of the newly regulated entities, that is a lot of lawyers.

The more rules that must be drafted and reviewed and complied with, the more the private sector will also need more staffing. In short, the private sector will need far more legal staffing at the same time that the government's needs will also be expanding, making it difficult for both sides to hire enough people.

While we have said that there is not enough staffing, it is important to recognize that this is not just a matter of numbers. It simply does not work to hire 100 or 1000 lawyers at the Commissions if they do not have relevant experience. This is not simply a matter of producing 453 rules. All of the rules must work together. The SEC/CFTC/Banking Dodd-Frank rules must all work together; ***and*** all of the Dodd-Frank rules must work with the existing bodies of securities, commodities and banking law, as well as with relevant sections of the Bankruptcy Code. Further, one must (or at least ought) take account of international law. One thousand lawyers without experience cannot complete this task in a year.[17]

And as far behind as the regulators may be in the rulemaking process, the volume of proposed rules, even though far from sufficient to meet the statutory task, has been overwhelming to private industry. No amount of additional government hiring to speed the process will make it less overwhelming to the private sector. And of course all these staffing problems are without the problems of actually implementing any compliance – all those problems yet loom.

D. Too Much Technology Staffing

Similarly, I have been told that there are not enough technology people in the United States (in fact in the world) to implement Dodd-Frank. I have no idea whether this is true. At a minimum, it points out the issue that the resources to implement Dodd-Frank are not just legal staffing resources.

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[16] Many institutions that previously had a single federal regulator will now have either two or three. For example, many banks will now be directly regulated not only by the banking regulators, but also by the CFTC and the SEC. Many investment funds that might previously have been subject only to the SEC will now be subject to the CFTC as well.

[17] Imagine that one were to hire 1,000 artists and give each of them a square piece of blank cardboard, instruct each of them to go off by him- or herself, and work very hard for a year, and, at the end of the year, they should collectively come back with a jigsaw puzzle that, when fit together, will look like the Mona Lisa. It would not work. At best, they would come back with *Dora Maar Au Chat*. http://en.wikipedia.org/wiki/Dora_Maar_au_Chat. This problem of co-ordination cannot be solved by hiring 10x more lawyers.

E. Too Tough Ain't Tough Enough

The problems of size and staffing have been compounded by both the legislators' and the regulators' approach to making laws and rules applicable to derivatives. Essentially, ***every requirement*** that is applicable to participants in the securities or futures markets is made applicable to the swaps markets, but also made ***stricter***. This is the wrong approach for a number of reasons. But, as I am simply focusing on raw size, this is the key point: the body of laws (and the related rules and infrastructure) applicable to broker-dealers under the Securities Exchange Act has had nearly 80 years to develop; the body of laws (and the related rules and infrastructure) applicable to listed futures, approximately 90 years. The notion that one could take these two bodies of law and reconstruct them (but in a stricter fashion) in a single year was too optimistic.

III. Where Are We Now

As the July 16 effective date of Dodd-Frank approaches, there are three possible viewpoints one can take as to the statute.

1. *Optimistic*. It is essentially a good law, but it cannot be ready for July 16.

2. *Resigned*. It is a well-meaning law, but it has very serious drafting problems that will create major problems whenever it is implemented and, in any case, it cannot be ready by July 16.

3. *Critical*. It is a law that was hastily drafted in response to a crisis even before the cause of that crisis had been carefully considered; the problems with the statute are becoming more obvious to observers as we have had time to analyze the words more carefully; the law would, if implemented, leave the financial regulatory system worse off than when it started; and, in any case, the statute cannot be ready for July 16.

There is no point in hiding that I am of the third viewpoint and was so even before Dodd-Frank had been proposed.[18] But that should not distract from the fact that, even for those who may be Dodd-Frank supporters, the July 16 date is not workable. This means that, on July 16, we do not move from the old financial regulatory structure (CFMA) to the new financial regulatory structure (Dodd-Frank). The old dies, but the new is not ready to be born. We are moving away from a

[18] *See, e.g., Meet the New Regulators: Same as the Old Regulators (Jan. 27, 2009).* This is an article I wrote approximately a year and a half before Dodd-Frank was adopted, explaining why the direction of financial "reform" was misguided. http://www.cadwalader.com/assets/client_friend/012209_Future_of_Financial_Regulation.pdf.

See also, more specifically, Some Concerns with the Derivatives Legislation (May 3, 2010), explaining that Dodd-Frank can not work as drafted, and what might be done to rescue the statute. http://www.cadwalader.com/assets/client_friend/050310_DerivativesLegislation.pdf.

regulatory framework – but not moving from one regulatory framework to another, but rather moving from one regulatory framework to nothing is ready.

IV. Where Do Market Participants Go from Here: Dealing with Contingencies

We are in a very unusual situation as to our market "regulations." In short, we do not have "regulations" – as the term is ordinarily used – meaning that we cannot look to the words of either a statute or any related rules for firm guidance as to conduct.

The statute has drafting problems where, among other things, even the single most important definition in the statute ("swap") cannot mean what it says. Even without those definitional problems, the statute does not really "work," at least in the sense that the statute requires certain things (including both rules and a market structure) that do not now exist.

The regulations to implement that statute are far from completed, and many of the proposals arguably also do not "work," in the sense that they would be difficult or even impossible to accomplish. On the somewhat positive side, the regulators are aware of at least some of the statutory problems and, in some cases, seem to be drafting definitions and other regulatory provisions that are not tied to the statutory language. But of course the absence of a relationship between the statutory language and the regulatory provisions raises its own problems as to what "law" is in effect and as to the basis on which the regulations may be claimed to rest.

Even if the proposed regulations were in place, there would be a further difficulty in actual compliance by the persons regulated by the law. That is, such compliance probably cannot "work" in the sense that the proposed legal and regulatory requirements – building a whole new compliance structure within a year, and then, in the case of non-U.S. banks, moving the entire structure out of the bank branch at the end of year, or, with some delay, in the case of U.S. banks – probably can not be done. Thus, market participants are left to the discretion of the regulators to adopt broad exemptions – which we must hope are effective by midnight on July 15.

If, as Chairman Gensler says, July 16 is a non-event, then it may be that there is nothing to do. However, it is hard to feel confident of that without more express guidance that is grounded in statutory authority. In the absence of certainty, market participants (meaning essentially everyone) must adopt a contingency plan to transact in markets that will not be governed by clear law, but, at best, by regulatory pronouncements, and, at worst, by private litigants. Below are some of the measures that it may be prudent to take.

A. Market Participants Generally

If one is of a pessimistic nature (and I suppose all lawyers are to some extent, and I am certainly demonstrating that I am), there may be some value to entering into contracts before July 16. From

that date onwards, there will be some level of uncertainty as to the application of Dodd-Frank, as we await further regulatory exemptive action, the breadth and basis of which are uncertain.

B. Non-ECPs and "Special Entities"

For persons (such as small businesses) that do not qualify as "eligible contract participants," any transaction that is a "swap" (under an uncertain definition) may be unavailable to them as of that date. They should try to enter into whatever "swaps" are relevant to their business before July 16 so as to avoid the possible market disruptions.

The same advice applies to "Special Entities." Because of the various "protections" afforded these entities, the swaps markets may either not be available to them as of such date or their access may be more limited.

C. U.S. "Corporates" and All Other Legal Entities

Such persons should consider which products the company trades or enters into that might be within the broad definition of "swap" contained in Dodd-Frank. Discuss with potential counterparties what are the counterparty's plans for trading on July 16.

Also firms should consider which transactions require a legal opinion to close. Firms should consider whether they will be able/willing to close without a legal opinion or with an opinion that has a Dodd-Frank carve-out.

D. Firms with Global Operations

Consider the possibility of shifting trading operations offshore so as to minimize potential legal uncertainty, at least in the immediate aftermath of the effective date.

E. Firms Potentially Subject to Dealer Registration

Assume, for this purpose, that the Commissions allow "notice registration" (meaning that a firm can be registered by sending an email to the CFTC and the SEC) without any significant rules that apply to swaps dealers, and that there continues to be material uncertainty as to the definition of the term "swap" and the definition of the term "swaps dealer." For firms that are not certain whether they fit within the definition of swaps dealer, there is an argument that it is prudent to register on the theory that (i) there will not be a body of existing regulations and (ii) if the firm fails to register, it is acting illegally.

Corporate groups that will register should select the legal entity or entities that they will want to register as swaps dealers. They should also identify the provisions of Dodd-Frank that will apply

without further rulemaking; *e.g.*, the requirement to appoint a Chief Compliance Officer, the prohibitions on trading swaps with non-ECPs, and the collateral-related notice requirements.

We note that one risk in taking such an approach is that the firm may not be able to withdraw from registration if the final regulations are too burdensome. A potential (very partial) solution to this problem might be that the firm include in its swap transactions a right to either terminate or to assign the transactions (although such rights will be resisted by some counterparties).

F. Non-U.S. Firms with Non-U.S. Regulators

Non-U.S. financial institutions may be advised to reach out to their home country regulators and request that these home country regulators seek guidance from U.S. regulators as to how Dodd-Frank will be applied to non-U.S. institutions. For example, non-U.S. regulators may wish to seek assurance from their U.S. counterparts that non-U.S. financial institutions may freely withdraw from registration as swaps dealers if the regulations prove too burdensome.

It would also be prudent to take up the discrimination problem in the Lincoln amendment.

G. SEC-Registered Broker-Dealers That Act as Securities-Based Swaps Brokers

On July 16, brokerage activities with respect to security-based swaps become subject not only to many of the securities laws, but also to many of the FINRA rules. There has not been a concerted regulator/industry plan to consider which FINRA rules would be relevant to swaps. That said, firms should consider which SEC/FINRA rules create litigation risk because they could give rise to private rights of action, as opposed to "mere" regulatory risk. For example, firms should be mindful of the requirement to send trade confirmations consistent with Rule 10b-10. Firms should also review their general supervisory and communications programs.

* * *

Please call your Cadwalader attorney if you would like to discuss contingency planning with respect to the effective date of Dodd-Frank. The table at the end of this memorandum provides a list of, and contact information for, some of the Cadwalader attorneys who are involved with specific legal issues raised by Dodd-Frank.

* * *

I am also posting a version of this memorandum on the website for the Center for Financial Stability, a nonpartisan organization. *See* *www.centerforfinancialstability.org*. If you would like to respond to

the questions in Appendix A, please email them to my address at slofchie@the-cfs.org and we will try to post them on the site either in summary form or anonymously as you indicate.

* * *

Steven Lofchie +1 212 504 6700 steven.lofchie@cwt.com

Appendix A

Leaving aside the question of whether Title VII of Dodd-Frank is good or bad,

1. What would be a reasonable length of time to adopt implementing rules, given the need to seek comment and to coordinate between regulators?

2. How much and what type of legal staffing would the regulators require?

3. How would one form estimates of the above?

4. How much time would industry require to implement the rules?

5. How much staffing and what type would be required?

6. How would one form estimates of the above?

You may email your response to slofchie@the-cfs.org.

Cadwalader Dodd-Frank Contacts[1]

Subject Area	Partner	Contact Information	
Agricultural Swaps	Athena Eastwood	+1 202 862 2294	athena.eastwood@cwt.com
	Paul Pantano	+1 202 862 2410	paul.pantano@cwt.com
Amendments to SOX	Louis J. Bevilacqua	+1 212 504 6057	louis.bevilacqua@cwt.com
	Penny M. Williams	+1 212 504 6403	penny.williams@cwt.com
Banking	Scott Cammarn	+1 704 348 5363	scott.cammarn@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
	Bradley Bondi	+1 202 862 2314	bradley.bondi@cwt.com
	Maurine Bartlett	+1 212 504 6218	maurine.bartlett@cwt.com
	Bryan Shipp	+1 212-504-5615	bryan.shipp@cwt.com
Broker-Dealers	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
	Maurine Bartlett	+1 212 504 6218	maurine.bartlett@cwt.com
	Glen Barrentine	+1 212 504 6833	glen.barrentine@cwt.com
	Jeff Robins	+1 212 504 6554	jeffrey.robins@cwt.com
Business Conduct Standards	Ivan Loncar	+1 202 862 6339	ivan.loncar@cwt.com
	Tony Mansfield	+1 202 862 2321	anthony.mansfield@cwt.com
	Greg Mocek	+1 202 862 2322	gregory.mocek@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
	Glen Barrentine	+1 212 504 6833	glen.barrentine@cwt.com
	Jeff Robins	+1 212 504 6554	jeffrey.robins@cwt.com
	Larry Stromfeld	+1 212 504 6291	lary.stromfeld@cwt.com
Capital and Margin for Non-banks	Tony Mansfield	+1 202 862 2321	anthony.mansfield@cwt.com
	Paul Pantano	+1 202 862 2410	paul.pantano@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
	Jeff Robins	+1 212 504 6554	jeffrey.robins@cwt.com

1 Cadwalader also makes available to subscribers an on-line library (the "**Cadwalader Cabinet**") that includes, among other things, substantial materials in regard to Dodd-Frank. Contact: Steven Lofchie (+1 212 504 6700) / steven.lofchie@cwt.com.

Subject Area	Partner	Contact Information	
Commodity Swap Dealers/Definitions	Paul Pantano	+1 202 862 2410	paul.pantano@cwt.com
	Tony Mansfield	+1 202 862 2321	anthony.mansfield@cwt.com
	Athena Eastwood	+1 202 862 2294	athena.eastwood@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
	Jeff Robins	+1 212 504 6554	jeffrey.robins@cwt.com
DCOs	Athena Eastwood	+1 202 862 2294	athena.eastwood@cwt.com
	Paul Pantano	+1 202 862 2410	paul.pantano@cwt.com
	Jeff Robins	+1 212 504 6554	jeffrey.robins@cwt.com
End-user Issues	Paul Pantano	+1 202 862 2410	paul.pantano@cwt.com
	Tony Mansfield	+1 202 862 2321	anthony.mansfield@cwt.com
	Liz Hastings	+1 202 862 2472	elizabeth.hastings@cwt.com
	Ivan Loncar	+1 202 862 6339	ivan.loncar@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
	Maurine Bartlett	+1 212 504 6218	maurine.bartlett@cwt.com
	Robert Davis	+1 212 504 2422	bob.davis@cwt.com
	James Frazier	+1 212 504 6963	james.frazier@cwt.com
	Bronislaw Grala	+1 212 504 6466	bronislaw.grala@cwt.com
	David Miller	+1 212 504 6318	david.miller@cwt.com
	Ray Shirazi	+1 212 504 6376	ray.shirazi@cwt.com
	Lary Stromfeld	+1 212 504 6291	lary.stromfeld@cwt.com
	Jeff Robins	+1 212 504 6554	jeffrey.robins@cwt.com
Executive Compensation and Corporate Governance	Shane J. Stroud	+1 212 504 6392	shane.stroud@cwt.com
	Linda Z. Swartz	+1 212 504 6062	linda.swartz@cwt.com
Hedge Fund Regulation	Drew Chapman	+1 212 504 6540	drew.chapman@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
	Maurine Bartlett	+1 212 504 6218	maurine.bartlett@cwt.com
	Gregg Jubin	+1 202 862 2485	gregg.jubin@cwt.com
	Nick Shiren (London)	+44 (0) 020 7170 8778	nick.shiren@cwt.com
	Ray Shirazi	+1 212 504 6376	ray.shirazi@cwt.com
	Alan Parness	+1 212 504 6342	alan.parness@cwt.com

Subject Area	Partner	Contact Information	
	Andrew Lom	+1 212 504 6143	andrew.lom@cwt.com
	Dorothy Mehta	+1 212 504 6846	dorothy.mehta@cwt.com
Insurance Reforms	Jennifer Donohue (London)	+44 (0) 020 7170 8628	jennifer.donohue@cwt.com
	Angus Duncan (London)	+44 (0) 020 7170 8640	angus.duncan@cwt.com
	Steven Lenkowsky	+1 212 504 6127	steven.lenkowsky@cwt.com
	David Miller	+1 212 504 6318	david.miller@cwt.com
	Frank Polverino	+1 212 504 6820	frank.polverino@cwt.com
	Ira Schacter	+1 212 504 6035	ira.schacter@cwt.com
	Malcolm P. Wattman	+1 212 504 6222	malcolm.wattman@cwt.com
	Neil J. Weidner	+1 212 504 6065	neil.weidner@cwt.com
Investment Advisers	Maurine Bartlett	+1 212 504 6218	maurine.bartlett@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
Living Will	George Davis	+1 212-504-6797	george.davis@cwt.com
	Mark Ellenberg	+1 202 862 2238	mark.ellenberg@cwt.com
	Greg Petrick	+1 212 504-6373	gregory.petrick@cwt.com
	John Rapisardi	+1 212-504-5585	john.rapisardi@cwt.com
	Jeff Robins	+1 212 504 6554	jeffrey.robins@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
	Scott Cammarn	+1 704 348 5363	scott.cammarn@cwt.com
	Richard Schetman	+1 212 504 6906	richard.schetman@cwt.com
CFTC - Manipulation and Deceptive Devices	Greg Mocek	+1 202 862 2322	gregory.mocek@cwt.com
	Tony Mansfield	+1 202 862 2321	anthony.mansfield@cwt.com
SEC - Manipulation and Deceptive Devices	Bradley Bondi	+1 202 862 2314	bradley.bondi@cwt.com
	Jeannine D'Amico	+1 202 862 2452	jeannine.damico@cwt.com
	Thomas Kuczajda	+1 202 862 2246	tom.kuczajda@cwt.com
	Douglas Fischer	+1 202 862 2276	douglas.fischer@cwt.com
Orderly Liquidation of Financial Companies, Including Executive Compensation Clawback	Mark Ellenberg	+1 202 862 2238	mark.ellenberg@cwt.com
	Jeff Robins	+1 212 504 6554	jeffrey.robins@cwt.com

Subject Area	Partner	Contact Information	
Position Limits; Position Reporting	Liz Hastings	+1 202 862 2472	elizabeth.hastings@cwt.com
	Tony Mansfield	+1 202 862 2321	anthony.mansfield@cwt.com
	Athena Eastwood	+1 202 862 2294	athena.eastwood@cwt.com
	Paul Pantano	+1 202 862 2410	paul.pantano@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
Recordkeeping and Reporting, including SDRs	Tony Mansfield	+1 202 862 2321	anthony.mansfield@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
Security-based Swaps/Definitions	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
	Jeff Robins	+1 212 504 6554	jeffrey.robins@cwt.com
Securitization and Rating Agency Reforms	Michael Gambro	+1 212 504 6825	michael.gambro@cwt.com
	Stu Goldstein	+1 212 504 6316	stuart.goldstein@cwt.com
	Pat Quinn	+1 212 504 6067	pat.quinn@cwt.com
SEFs	Greg Mocek	+1 202 862 2322	gregory.mocek@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
Special Entities	Lary Stromfeld	+1 212 504 6291	lary.stromfeld@cwt.com
	Robert Davis	+1 212 504 2422	bob.davis@cwt.com
	Bronislaw Grala	+1 212 504 6466	bronislaw.grala@cwt.com
	Ivan Loncar	+1 212 504 6339	ivan.loncar@cwt.com
	James Frazier	+1 212 504 6963	james.frazier@cwt.com
Swap Push-Out	Scott Cammarn	+1 704 348 5363	scott.cammarn@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
	Jeff Robins	+1 212 504 6554	jeffrey.robins@cwt.com
Volcker Rule	Scott Cammarn	+1 704 348 5363	scott.cammarn@cwt.com
	Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
	Jeffrey Robins	+1 212 504 6554	jeffrey.robins@cwt.com
Whistleblowers	Bradley Bondi	+1 202 862 2314	bradley.bondi@cwt.com
	Greg Mocek	+1 202 862 2322	gregory.mocek@cwt.com
	Tony Mansfield	+1 202 862 2321	anthony.mansfield@cwt.com
European Regulatory Initiatives			
Alternative Investment Fund	Nick Shiren (London)	+44 (0) 020 7170 8778	nick.shiren@cwt.com

Subject Area	Partner	Contact Information	
Managers Directive	Alix Prentice (London)	+44 (0) 020 7170 8710	alix.prentice@cwt.com
	Assia Damianova (London)	+44 (0) 020 7170 8564	assia.damianova@cwt.com
	Marco Crosignani (London)	+44 (0) 020 7170 8678	marco.crosignani@cwt.com
Amendments to MiFID	Doron Ezickson (London)	+44 (0) 020 7170 8525	doron.ezickson@cwt.com
	Alix Prentice (London)	+44 (0) 020 7170 8710	alix.prentice@cwt.com
Amendments to the Market Abuse Directive	Doron Ezickson (London)	+44 (0) 020 7170 8525	doron.ezickson@cwt.com
	Alix Prentice (London)	+44 (0) 020 7170 8710	alix.prentice@cwt.com
CRD III	Alix Prentice (London)	+44 (0) 020 7170 8710	alix.prentice@cwt.com
European Market Infrastructure Regulation (OTC derivatives, central counterparties and trade repositories)	Doron Ezickson (London)	+44 (0) 020 7170 8525	doron.ezickson@cwt.com
	Nick Shiren (London)	+44 (0) 020 7170 8778	nick.shiren@cwt.com
	Alix Prentice (London)	+44 (0) 020 7170 8710	alix.prentice@cwt.com
	Assia Damianova (London)	+44 (0) 020 7170 8564	assia.damianova@cwt.com
	Marco Crosignani (London)	+44 (0) 020 7170 8678	marco.crosignani@cwt.com
REMIT (Regulation on Energy Market Integrity and Transparency)	Doron Ezickson (London)	+44 (0) 020 7170 8525	doron.ezickson@cwt.com
	Alix Prentice (London)	+44 (0) 020 7170 8710	alix.prentice@cwt.com
	Assia Damianova (London)	+44 (0) 020 7170 8564	assia.damianova@cwt.com
Short selling and credit default swaps	Alix Prentice (London)	+44 (0) 020 7170 8710	alix.prentice@cwt.com
	Edmond Curtin (London)	+44 (0) 020 7170 8663	edmond.curtin@cwt.com
Skin-in-the-game Retention Requirements (Art 122a of the Capital Requirements Directive)	Nick Shiren (London)	+44 (0) 020 7170 8778	nick.shiren@cwt.com
	Marco Crosignani (London)	+44 (0) 020 7170 8678	marco.crosignani@cwt.com
	Robert Cannon (London)	+44 (0) 020 7170 8735	robert.cannon@cwt.com