Derivatives

(This is a summary of this topic. For more in-depth information, see "Regulation of Over-the-Counter Derivatives Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.")

Title VII of the Dodd-Frank Act, referred to herein as the "Derivatives Title," imposes a regulatory regime on over-the-counter ("OTC") derivatives and the market for such derivatives. The primary goals of the legislation and related rulemaking are to increase the transparency and efficiency of the OTC derivatives market and reduce the potential for counterparty and systemic risk. The main mechanisms for achieving this are:

- to require that as many product types as possible be centrally cleared and traded on exchanges or comparable trading facilities;
- to subject swap dealers and major market participants to capital and margin requirements; and
- to require the public reporting of transaction and pricing data on both cleared and uncleared swaps.

Many market participants could be affected by increased costs and increased regulatory oversight and reporting. The impact on some thinly capitalized, leveraged investment funds and structured finance vehicles could be significant and may make certain structures unfeasible. In addition, the language of the Act is ambiguous as to whether new margin requirements may apply retroactively to existing swap transactions.

With limited exceptions, the provisions of the Derivatives Title become effective on the later of 360 days following enactment and, to the extent a provision requires rulemaking, not less than 60 days after publication of the final rule. Many key concepts, processes and issues under the Derivatives Title have been left to the relevant regulators, primarily the CFTC and the SEC, to define and address. The rulemaking generally is required to be completed within 360 days following enactment.

Division of Regulatory Authority[1]

The Act divides the regulation of the OTC derivatives market between "swaps" regulated by the CFTC and "security-based swaps" regulated by the SEC.[2] "Swap" is broadly defined to include most types of OTC derivatives, subject to a carve-out for "security-based swaps" and certain other specified exceptions. "Security-based swap" is defined as a swap that is based on, among other things, a narrow-based security index or a single security or loan, including in each case any interest therein or the value thereof. The definition of "swap" excludes (and consequently "security-based swap" excludes), among other categories, options on securities, or groups or indices of securities, that are subject to the Securities Act and the Exchange Act.

Expanded Application of Securities Laws[3]

The Act repeals the provisions enacted under the Gramm-Leach-Bliley Act and the Commodity Futures Modernization Act of 2000 that prohibited the SEC from regulating security-based swaps beyond the

[1] Act § 712.

[2] Except where otherwise indicated, the term "swap" refers to both swaps and security-based swaps, and "swap dealer" refers to both swap dealers and security-based swap dealers.

[3] Act §§ 761 (to be codified at 15 U.S.C. 78c(a)), 762 , 763 (to be codified at 15 U.S.C. 78a *et seq.*), 766 (to be codified at 15 U.S.C. 78a *et seq.*) & 768 (to be codified at 15 U.S.C. 77b(a)).

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anti-fraud and anti-manipulation provisions of the Securities Act and the Exchange Act, and the insider trading provisions of the Exchange Act, and adds regulation of security-based swaps under the Securities Act and the Exchange Act.

Mandatory Clearing and Exchange Trading Requirements[4]

Subject to limited exemptions, the Act requires swaps to be cleared if they are of a type that the CFTC or SEC, as applicable, determines must be cleared and are accepted for clearing by a "derivatives clearing organization" (a "DCO") (in the case of a swap) or a clearing agency (in the case of a security-based swap). Swaps subject to the clearing requirement also must be traded on a board of trade designated as a contract market or a swap execution facility (in the case of a swap) or on a security-based swap execution facility or a national securities exchange (in the case of a security-based swap), unless no relevant facility will make the particular swap available to trade.

A swap will be exempt from the clearing and exchange trading requirements if one of the counterparties to the swap is an end user that is hedging its own commercial risk. The end user can elect to require the swap to be cleared and traded on an exchange or execution facility even if the exemption is available.

The end user exemption applies only to a swap counterparty that "(i) is not a financial entity; (ii) is using swaps to hedge or mitigate financial risk; and (iii) notifies the CFTC or SEC, in a manner set forth by the CFTC or SEC, how it generally meets its financial obligations associated with entering into non-cleared swap."[5]

"Financial entity" means any of the following:

- a swap dealer or a Major Participant (as defined below);
- a commodity pool as defined in the CEA;
- a "private fund," defined to mean a fund that would be required to register as an investment company but for the exemption provided by Sections 3(c)(1) or 3(c)(7) of the 1940 Act;[6]
- an ERISA plan; or
- a person predominantly engaged in activities that are in the business of banking or financial in nature.[7]

For purposes of the clearing exemption for end users of swaps, the term "financial entity" expressly excludes captive finance companies that meet specified criteria.[8]

Swaps entered into prior to enactment (or post-enactment but prior to the effective date of the clearing requirement) will not be subject to the clearing or exchange trading requirements but will be subject to reporting and recordkeeping requirements.

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[4] Sections 723 (to be codified at 7 U.S.C. 2) & 763 (to be codified at 15 U.S.C. 78a *et seq.*).

[5] Act §§ 723(a)(3) (to be codified at 7 U.S.C. 2) & 763(a) (to be codified at 15 U.S.C. 78a *et seq.*).

[6] Given this definition, most CDOs and many other types of SPEs and investment funds will be financial entities for purposes of the Derivatives Title.

[7] "Financial in nature" is as defined in Section 4(k) of the BHCA.

[8] No parallel exclusion is made for purposes of the clearing exemption in respect of security-based swaps, presumably reflecting an assumption that the hedging instruments typical of the activities of a captive finance company would include interest rate and currency hedges.

Definitions for Major Swap Participant/Major Security-Based Swap Participant[9]

The Act uses the term "Major Swap Participant" to refer to a participant in swaps regulated by the CFTC and "Major Security-Based Swap Participant" to refer to a participant in security-based swaps regulated by the SEC. The term "Major Participant" is used herein to refer to both (and a particular entity may fall within both categories for purposes of the Derivatives Title). Major Participants are subject to registration, capital, margin and other compliance requirements under the Act.

A Major Participant is any entity that is not a swap dealer that satisfies any one of the following alternative conditions:

- It maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC or SEC, excluding positions held for hedging or mitigating commercial risk (or hedging or mitigating any risk directly associated with the operation of an ERISA plan);
- Its outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
- It is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate federal banking agency, and it maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC or SEC.

The definitions of Major Swap Participant and Major Security-Based Swap Participant are identical in substance, except that only the definition of Major Swap Participant expressly excludes captive finance companies that meet the captive finance company standard described above in connection with the end user exemption.

The key term, "substantial position," as well as "highly leveraged" and other threshold requirements used for purposes of determining if an entity is a Major Participant, are not defined and are to be addressed in the rulemaking process.

Mandatory Registration, Capital and Margin Requirements[10]

The Act requires swap dealers and Major Participants to register with the CFTC or SEC not later than one year after enactment, and to satisfy capital and margin requirements to be established by the applicable regulatory authority. The CFTC or SEC, as applicable, will set capital and margin requirements for nonbank swap dealers and Major Participants. The appropriate federal banking regulator will set the capital and margin requirements for banks that are required to register as swap dealers or Major Participants. The margin requirements to be set by the applicable regulatory authority for swap dealers and Major Participants apply only to uncleared swaps; the DCO or clearing agency (as applicable) will set the margin requirements applicable to cleared swaps.

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[9]Act §§ 721 (to be codified at 7 U.S.C. 1a) & 761 (to be codified at 15 U.S.C. 78c(a)).

[10]Act §§ 731 (to be codified at 7 U.S.C. 1 *et seq.*) & 764 (to be codified at 15 U.S.C. 78a *et seq.*).

Public Reporting of Swap Data[11]

Among other swap data to be reported pursuant to the Act, the CFTC or SEC, as applicable, is to promulgate rules and regulations for "real-time public reporting" of swap transaction and pricing data in such form and such times as the applicable regulator determines appropriate. "Real-time public reporting" means the reporting of data relating to a swap transaction as soon as is technologically practicable after execution.

Segregation of Swap Collateral[12]

Any person that holds margin for DCO-cleared swaps for customers is required to register with the CFTC as a futures commission merchant ("FCM"). Any person that holds margin for clearing agency-cleared swaps for customers is required to be registered with the SEC as a broker-dealer or security-based swap dealer. The FCM, the broker-dealer or the security-based swap dealer, as applicable, is required to segregate such funds or other property held. The use and investment of segregated funds will be subject to such rules as the CFTC or SEC may promulgate.

Uncleared swaps are not subject to the above statutory requirements. However, with respect to uncleared swaps entered into with a swap dealer or a Major Participant, the counterparty is entitled to require the swap dealer or Major Participant to maintain property posted as initial margin in a segregated account. This option of the counterparty does not apply to variation margin.

The Volcker Rule[13]

The Volcker Rule's prohibition against "proprietary trading" by insured depository institutions and their affiliates could have far-reaching consequences for the conduct of derivatives activities by banking organizations. See "The Volcker Rule."

The Lincoln Provision (Swaps "Push-Out" by Banks)[14]

The Act also includes a controversial provision that prohibits "federal assistance" to any "swaps entity." Federal assistance is defined for this purpose as including advances from any Federal Reserve credit facility or discount window (subject to an exception for a program with broad-based eligibility under the emergency lending powers), or FDIC insurance or guarantees. "Swaps entity" is defined as any swap dealer or Major Participant that is registered under the CEA or the Exchange Act, other than a Major Participant that is an insured depository institution. Therefore, an insured depository institution will be a "swaps entity" for purposes of this provision only if it is a swap dealer.

This provision effectively requires any bank or other entity with access to Federal Reserve credit or FDIC assistance, and whose derivatives activities constitute acting as a swap dealer, to cease (after a transition period) engaging in swap activities other than those specifically permitted. The specifically permitted swap activities include interest rate and currency swaps, cleared credit derivatives on investment grade securities, and hedging activities directly related to the insured depository institution's activities.

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[11]Act §§ 727 (to be codified at 7 U.S.C. 2(a)) & 763(i) (to be codified at 15 U.S.C. 78a *et seq.*).

[12]Act §§ 724 (to be codified at 7 U.S.C. 6d) & 763 (to be codified at 15 U.S.C. 78a *et seq.*).

[13]Act § 619 (to be codified at 12 U.S.C. 1841 *et seq.*).

[14]Act § 716.

Nonpermitted swap activities may be conducted in a separately capitalized nonbank affiliate. The effective date of this provision is deferred until two years after the effective date of the Derivatives Title (which is approximately three years after enactment of the Act) and a transition period of up to two years, with a potential, discretionary extension of one additional year, follows that deferred effective date.

Extraterritorial Application[15]

The Derivatives Title does not include any express exemptions for non-U.S. entities from the requirements applicable to swap dealers or Major Participants. Many non-U.S. entities will be subject to regulation as swap dealers because they conduct substantial activities of that type in the U.S. However, the extent to which the Derivatives Title would affect their activities outside the U.S. remains to be clarified during the rulemaking process, and presumably will include coordination with relevant foreign regulatory authorities.

The Derivatives Title also leaves open issues with respect to non-U.S. entities that on the basis of their swap positions may be categorized as Major Participants. For example, it is uncertain whether such entities would be excluded by regulation from the Major Participant category if they enter into swaps only outside the U.S. and only with non-U.S. entities. The intended scope of the definition of "Major Participant," and in particular the extent to which it may apply to entities outside the U.S., may not be known with certainty until the rulemaking process has been concluded (if then).

[15]Act §§ 722 (to be codified at 7 U.S.C. 2(a)(1)) & 772(b) (to be codified at 15 U.S.C. 78 dd).