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ADVISORY | Dodd-Frank Act

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NEW RULES FOR DERIVATIVES

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). Title VII of the Act sets forth the new legislative framework for derivatives.

- The Act creates an extensive new regulatory framework for "swaps" and "security-based swaps," capturing substantially all derivatives transactions that previously were exempt from regulation under the Commodity Futures Modernization Act.
- The Act contemplates mandatory clearing and trading on regulated facilities for many derivatives contracts, with an exception for non-financial end users.
- "Swap dealers" and "major swap participants" will be subject, among other things, to capital and margin requirements, business conduct rules and special duties in their dealings with governmental entities, ERISA and governmental plans and endowments. While many end users will not be directly regulated, they often will be affected indirectly as their counterparties become subject to new requirements, in particular with respect to margin rules.
- Other significant provisions include the swaps "pushout" rule, collateral segregation and real-time swap transaction reporting requirements, position limits and large trader reporting, and the application of the securities laws to security-based swaps.
- Significant uncertainties remain to be clarified in rulemaking proceedings. The Act contemplates that its principal provisions will become effective in roughly one year. The coming year will be a period of intense rulemaking efforts, with limited time for the implementation of compliance measures once implementing regulations have been finalized.

Swaps and Security-Based Swaps

The Act aims to sweep the universe of previously unregulated derivatives into the new regulatory framework, and divides this universe into two broad categories:

- *Swaps*. The term "swap" is defined broadly and includes options, swaps and other transactions based on rates, commodities, securities, debt instruments, indices, quantitative measures and other financial or economic interests, subject to certain exceptions. Building upon the definition of previously exempt "swap agreements" under Section 206A of the Gramm-Leach-Bliley Act, the Act brings previously unregulated derivatives into the new framework. Swaps are subject to CFTC jurisdiction. Swaps do not include security-based swaps, as discussed below.
- *Security-Based Swaps*. "Security-based swaps" are swaps based on individual securities or loans, on narrow-based securities indices, or on events affecting individual issuers of securities or issuers of securities in a narrow-based securities index. Security-based swaps are subject to SEC jurisdiction.

The Act seeks to establish parallel rules for swaps and security-based swaps.[1] Mixed swaps, which combine features of swaps and security-based swaps, are to be regulated jointly by the CFTC and SEC. Parties seeking to list or trade novel derivatives products having both commodities and securities features may petition the CFTC and SEC for a determination of the product's regulatory status. The CFTC and SEC are required to consult and coordinate with one another (and with the federal banking regulators) in exercising their jurisdiction over swaps and may challenge each others' actions in court in the event of a dispute.

While the basic approach is comprehensive and quite straightforward, the definitional provisions are complex in detail. Care must be taken in evaluating the status of individual derivatives products. For example, the "swap" definition excludes certain transactions that are already regulated as securities, including options on securities and foreign exchange options traded on registered securities exchanges. Other exclusions remove from the scope of the Act commodity and security futures, leverage contracts, and forward transactions for nonfinancial commodities intended for physical settlement, as well as deposit and savings accounts, certificates of deposit and other "identified banking products." Swaps based on government securities (other than municipal securities) are excluded from the security-based swap definition and thus are subject to regulation by the CFTC.

Foreign exchange swaps and forwards, which were the subject of considerable debate during the legislative process, will be considered "swaps." The Treasury Secretary may, however, make a reasoned determination based on specified criteria that such transactions, to the extent they are not cleared or traded through regulated facilities, should be exempt. Even if that determination is made, reporting requirements and certain business conduct standards would apply.

Questions of interpretation undoubtedly will arise. For example, the definition of security-based swaps leaves some doubt as to the classification of credit default swaps, in particular credit default swaps based on loans or loan baskets or indices, as swaps or security-based swaps. Similarly, the "swap" definition might be read to encompass certain kinds of insurance contracts, which has added significance given that the Act provides that swaps may not be regulated as insurance under state law. The CFTC and SEC likely will be urged to clarify these and other issues though rulemaking.

Clearing and Trade Execution

The effort to require central clearing and exchange trading for many derivative transactions is at the heart of two basic purposes of the Act – reducing systemic risk and increasing market transparency. At the same time, the mandatory clearing and exchange trading provisions have been controversial, in particular due to the increased margin requirements (and hence increased costs) likely to be associated with central clearing.

Mandatory Clearing

The Act contemplates that the CFTC and SEC will, on an ongoing basis, review swaps and categories or classes of swaps with a view to determining whether clearing should be required. Factors to be considered include the existence of significant outstanding exposures, trading liquidity and the availability of appropriate operational expertise and resources. Where the CFTC or SEC determine

[1] The rules for swaps are put in place through amendments to the Commodity Exchange Act, and the rules for security-based swaps are embedded in the Securities Act of 1933 (the Securities Act) and Securities Exchange Act of 1934 (the Exchange Act). Because the regimes are nearly identical, for simplicity this Advisory uses the term "swap" to refer to swaps and security-based swaps, unless otherwise indicated. Similarly, this Advisory uses the term "swap dealer" to refer to both swap dealers and security-based swap dealers, and "major swap participant" to refer to both major swap participants and major security-based swap participants.

that a particular type of swap should be cleared but no clearing organization accepts the swap for clearing, the CFTC or SEC are directed to investigate and take appropriate action.[2] Mandatory clearing will not be applied to existing swap positions, so long as the positions are reported to swap data repositories in a timely fashion under rules to be promulgated by the CFTC and SEC.

Clearing organizations will be required to offset swaps with the same terms and conditions on an economically equivalent basis within the clearing organization, and to provide for non-discriminatory clearing of transactions executed bilaterally or on unaffiliated facilities. In a similar vein, the Act calls on the CFTC and SEC to adopt rules, including possible ownership and control limitations, to mitigate conflicts of interest that may arise with respect to ownership of regulated clearing and trading facilities by bank holding companies, certain non-bank financial institutions, swap dealers and major swap participants.

Trade Execution

Swaps that are required to be cleared must be executed on a designated contract market, securities exchange or swap execution facility, unless no such institution makes the transaction available to trade.

End-User Exception

The end-user exception to the clearing and trade execution requirements was another principal focus of the debate during the legislative process. The Act contains a carefully limited end-user exception for counterparties that are not "financial entities," are using swaps to hedge or mitigate commercial risks, and have notified the CFTC and/or SEC as to how they generally meet their financial obligations associated with non-cleared swaps.

"Financial entities" that will not benefit from the end-user exception include swap dealers and major swap participants, commodity pools, private funds (including hedge funds), certain employee benefit plans, and persons predominantly engaged in banking or other activities that are financial in nature. Depository institutions, farm credit institutions and credit unions with less than $10 million in assets may be excepted from the "financial entity" designation. Financial entities for this purpose will not include finance subsidiaries, *i.e.*, entities whose primary business is providing financing and who use derivatives to hedge interest rate and foreign currency exposures, at least 90% of which arise from financing for the purchase or lease of products, at least 90% of which are manufactured by an affiliate.[3]

Affiliates of exempt persons may benefit from the end-user exception when hedging or mitigating commercial risks of the exempt person. The exception will not be available if the affiliate is a swap dealer, major swap participant, private fund, commodity pool or bank holding company with more than $50 billion in assets.

Where clearing is not required, the non-swap dealer and non-major swap participant counterparty may nonetheless elect to require that the swap be cleared. More generally, the non-swap dealer and

[2] Unlike the Administration's original proposal, the Act contains no reference to whether a particular type of swap transaction has been "standardized." Similarly, while intermediate versions had made explicit that clearing could be made mandatory only if a clearing organization accepted a given type of swap for clearing, this is less certain under the final Act.

[3] The special provisions for finance subsidiaries apply only with respect to swaps, and not security-based swaps, presumably because security-based swaps are not used to hedge interest rate and FX risks.

non-major swap participant counterparty may select the clearing organization to be used in clearing a swap.

Issuers that are reporting companies must obtain approval by an appropriate committee of the company's board or other governing body prior to entering into swaps using the end-user exception.

Swap Dealers and Major Swap Participants

The principal targets of the new regulatory requirements are "swap dealers" and "major swap participants."[4]

Swap Dealers

The Act defines "swap dealer" to include any person who holds itself out as a dealer in swaps, makes a market in swaps, "regularly enters into swaps with counterparties as an ordinary course of business for its own account", or otherwise becomes known as a dealer or market maker in swaps. Persons who enter into swaps for their own account but not as part of a regular business are excluded, as are entities that engage in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of their customers. Insured depositary institutions that enter into swaps with customers for whom they are originating loans are also excluded.[5]

It is not clear whether the distinction drawn under the Exchange Act between a "dealer" and a non-dealer "trader" (who buys and sells for its own account but does not provide other services usually provided by dealers, such as providing market quotes) will be applied in this context. The wording of the swap dealer definition is broader than one might have expected, and could be read to cover entities that maintain even relatively small proprietary swap trading books. If construed broadly, this provision could capture a large number of market participants that would not ordinarily view themselves as dealers. Rulemaking in this area will merit particular attention.

Major Swap Participants

"Major swap participant" means any person, other than a swap dealer:

- who maintains a substantial position in swaps in any major category determined by the CFTC or SEC, excluding (i) positions held for hedging or mitigating commercial risk and (ii) positions maintained by ERISA plans for the primary purpose of hedging or mitigating risks directly associated with plan operations;
- whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or
- that is a highly leveraged financial entity that is not subject to capital requirements established by an appropriate federal banking agency and that maintains a substantial position in swaps in any major category determined by the CFTC or SEC.

[4] A variety of other market participants will be subject to specific regulation under the Act, including derivatives clearing organizations, swap data repositories and swap execution facilities. These regulations will be of more specialized interest and are not discussed in this Advisory.

[5] This exclusion does not apply with respect to institutions that originate security-based swaps for their loan customers, perhaps because the exception was felt to be necessary only for interest rate swaps as the form of swap most commonly entered into for hedging purposes in connection with borrowings.

There is an exclusion for finance subsidiaries, *i.e.*, entities whose primary business is providing financing and who use derivatives to hedge interest rate and FX exposures, at least 90% of which arise from financing for the purchase or lease of products, at least 90% of which are manufactured by an affiliate.[6]

The definition is replete with terms that call out for clarification in the rulemaking process. It seems to target entities with swaps activities at systemically significant levels, with lower thresholds for financial than for commercial entities. It will be difficult, however, to predict the scope of the provision with any confidence until the rulemaking process has progressed.

Regulatory Requirements for Swap Dealers and Major Swap Participants

Swap dealers and major swap participants will be subject to a range of new registration, recordkeeping, documentation, conflicts of interest management and other requirements. The debate during the legislative process focused on capital and margin requirements, new business conduct standards and special rules for dealings with special entities:

- *Capital and Margin Requirements*. These entities' swaps activities will be subject to capital requirements and, with respect to non-cleared swaps, to initial and variation margin requirements. The requirements are to be set by the CFTC and SEC and, for swap dealers and major swap participants that are banks, by the applicable prudential regulator at levels that help ensure the safety and soundness of the entity and that are appropriate for the risk associated with non-cleared swaps. The use of non-cash collateral is to be permitted to the extent consistent with the financial integrity of the swap markets and preserving the stability of the U.S. financial system.

  The rules on capital and margin were a major focus of the legislative debate because of their potential for increasing the cost to end users of establishing and maintaining hedges using derivatives. For reasons that are not entirely clear, an exemption in prior versions from margin requirements for commercial end users with respect to non-cleared swaps was not included in the final bill. The lack of such an exception prompted calls for a corrections bill to be passed before the Act's margin provisions become effective. By letter of June 30, 2010, Senators Dodd and Lincoln sought to establish the legislative intent to protect commercial end users from burdensome margin requirements. The concern is heightened given that there is no express exemption for legacy positions, with the result that end users might be required to post margin under new rules on trades entered into before the new rules were enacted. These issues undoubtedly will be the focus of special attention during the rulemaking process.
- *Business Conduct Standards*. Rules to be adopted by the CFTC and SEC are to establish business conduct standards that may pose considerable compliance challenges. Among other things, the Act calls for the CFTC and SEC to establish duties for swap dealers and major swap participants to verify their counterparties' status as eligible contract participants, to disclose material risks and characteristics of transactions, to disclose any "material incentives or conflicts of interest" they may have with respect to a transaction, and to communicate with their counterparties" in a fair and balanced manner based on principles of fair dealing and good faith." In addition, the CFTC and SEC are given broad authority to enact additional rules relating to fraud, manipulation, abusive practices and other matters.

[6] The exclusion for finance subsidiaries tracks the corresponding provision in the end-user exception from mandatory clearing, see note 3 above, and for similar reasons the exclusion applies only with respect to major swap participants, and not with respect to major security-based swap participants.

- *Duties With Respect to Special Entities*. Heightened business conduct standards will apply in dealings with "special entities" (*i.e.*, governmental entities, ERISA and governmental plans, and endowments).
  - A swap dealer and major swap participant acting as an *advisor* to a special entity will have a duty to act in the best interests of the special entity and must use reasonable efforts to obtain information allowing for a reasonable determination that a recommended swap is in the special entity's best interests.
  - When acting as a *counterparty* to a special entity, swap dealers and major swap participants must give written disclosure of the capacity in which they are acting and comply with rules established by the CFTC or SEC with regard to the special entity having access to the advice of a qualifying "independent representative" with respect to the transaction. It is not clear whether these rules will apply with respect to all special entities and whether the rules will effectively require that an independent representative be used in all cases.

The heightened duties for dealings with special entities do not apply in transactions executed on an exchange or swap execution facility where the swap dealer or major swap participant does not know the identity of the counterparty.

Swaps "Pushout" Provision

The swaps "pushout" provision originally introduced by Senator Blanche Lincoln seeks to prohibit the use of "federal assistance" – including FDIC insurance and guarantees and certain Federal Reserve programs – in connection with the activities of swap dealers or major swap participants. Following last minute compromises, the final provision allows banking entities to maintain relevant swaps activities so long as they are placed into separate non-bank affiliates. In addition, there are exceptions for insured depository institutions to the extent they are major swap participants (and not swap dealers) and with respect to hedging and risk mitigation activities, for swaps activities involving assets that are permissible for investment by national banks (including interest rate and foreign exchange swaps, but not including many commodities transactions and swaps on equity securities), and for cleared credit defaults swaps. There is uncertainty, however, as to whether and how these exceptions will be applied with respect to uninsured branches and agencies of foreign banks.

Relevant banking entities will need to review the pushout provision in conjunction with the Volcker Rule on proprietary trading.[7] Together these provisions could have a significant impact on these entities' swaps activities.

Segregation of Collateral

Persons accepting collateral in connection with swaps transactions must be registered with the CFTC or SEC, either as futures commission merchants with respect to swaps or as a broker-dealer or security-based swap dealer with respect to security-based swaps. Collateral for cleared swaps must be treated as belonging to the customer and may not be commingled, except in accounts with bank or trust companies or with a clearing organization and in connection with the application for settlement or margining in the ordinary course.

With respect to non-cleared swaps, swaps dealers and major swap participants must notify their counterparties of the right to require segregation, and segregated collateral must be held with an independent third party custodian. If segregation is not required, the swap dealer or major swap

[7] For a description of the Volcker Rule, see Covington Advisory Dodd-Frank Act: Final Volcker Rule Provisions, July 20, 2010.

participant must report on its back office procedures regarding margin and collateral on a quarterly basis.

Reporting of Swap Transactions and Pricing Data

In another significant change, the CFTC and SEC are called upon to promulgate rules requiring real-time public reporting – as soon as technologically practicable – of transaction data, including price and volume, for swaps that are required to be cleared or which are cleared on a voluntary basis. For transactions that are not cleared, real-time public reporting will be required in a manner that does not disclose the transactions and market positions of any person. Rulemaking is also to identify appropriate criteria for determining what constitutes a block trade, along with an appropriate time delays for their reporting to the public.

Position Limits and Large Trader Reporting

The Act calls upon the CFTC to establish limits on the amount of positions, excluding bona fide hedging transactions, with respect to physical commodities (other than excluded commodities) in order to prevent excessive speculation and manipulation, and to protect the availability of liquidity and the operation of the price discovery function of underlying markets. Position limits are to be aggregated across designated contract markets and foreign boards of trade providing access to participants in the United States. Similarly, in order to prevent fraud and manipulation, the SEC is to establish limits on security-based swap positions, which may be aggregated with positions in underlying securities or loans and other related instruments. Traders that exceed relevant limits must file reports with the CFTC or SEC.

Security-Based Swaps as Securities

The Act adds security-based swaps to the definition of "security" under both the Securities Act and the Exchange Act, thereby subjecting security-based swaps to the full range of the securities laws, in addition to the new requirements introduced by the Act itself. The implications are likely to become fully clear only with time. On some questions, the Act provides special rules:

- *Registration*. Security-based swaps may not be sold or offered to persons who are not eligible contract participants unless a registration statement with respect to the security-based swap is in effect, and such transactions may be effected only on a national securities exchange.[8] The registration requirement applies notwithstanding the availability of an exemption under section 3 or section 4 of the Securities Act.
- *Beneficial Ownership*. For purposes of Exchange Act sections 13 and 16, a person will be deemed to have acquired beneficial ownership of an equity security based on the purchase or sale of a security-based swap only to the extent the SEC has determined that such purchase or sale provides incidents of ownership comparable to direct ownership.
- *Security-Based Swap Agreements*. The Act defines "security-based swap agreements" as swaps based on a broad-based group or index of securities. Security-based swaps agreements generally are swaps (and subject to CFTC regulation), but the Act also subjects them to antimanipulation, antifraud, and certain other rules under the securities laws.

[8] The Act also raises the requirements for qualification as an eligible contract participant. Governmental entities will be required to own or invest at least $50 million (up from the current requirement of $25 million) on a discretionary basis in order to qualify. Individuals must hold discretionary investments (rather than total assets) of $10 million (or $5 million for risk management transactions) in order to be eligible.

FERC, CFTC, and State Jurisdiction

The Act expressly preserves FERC and state regulatory authority over transactions subject to FERC or state approved tariff or rate schedules that are not executed or cleared on a registered entity or trading facility or that are executed or cleared on a registered entity or trading facility owned or operated by a regional transmission organization or independent system operator.

It also preserves the CFTC's statutory authority over transactions entered into pursuant to FERC or state approved tariff or rate schedules, and preserves the CFTC's jurisdiction over transactions that are executed or cleared on a registered entity or trading facility not owned or operated by a regional transmission organization or independent system operator. The CFTC may also exempt certain transactions from regulation where overlap occurs with FERC or state regulatory authorities, if the CFTC finds that such exemption would be in the public interest.

International Aspects

The Act provides that the provisions regarding swaps will not apply to activities outside the United States unless those activities have a direct and significant connection with activities in, or an effect on, U.S. commerce or contravene rules promulgated by the CFTC to prevent evasion. With respect to security-based swaps, the Act provides that it shall not apply with respect transactions outside U.S. jurisdiction, unless a transaction contravenes rules promulgated by the SEC to prevent evasion.

Overall, these general provisions leave many questions unanswered. For example, there is no provision similar to Exchange Act Rule 15a-6 regarding swap-related activities that foreign entities may undertake with respect to U.S. customers without registration in the U.S. as a swap dealer or major swap participant. This is another area where the CFTC and SEC likely will be pressed to provide guidance.

The Act calls upon the CFTC and SEC to conduct a joint study of the regulation of swaps and clearing agencies in the U.S., Asia and Europe and report to Congress in 18 months. If at any time the CFTC or SEC determines that the regulation of swaps in a foreign country undermines the stability of the U.S. financial system, it may, in consultation with the Treasury Secretary, prohibit entities domiciled in that country from participating in swaps-related activities in the Unites States.

Transitional Rules

The provisions of the Act generally are to become effective on the later of (i) 360 days after the date or enactment or (ii) to the extent a provision requires a rulemaking, not less than 60 days after publication of the final rule.

If you would like to discuss the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

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