

# OTC Derivatives and The Dodd-Frank Act

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# Introduction

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The Dodd-Frank Act (the “DFA”) established a vast new statutory regime covering the OTC swaps market (most of which is contained in Title VII of the DFA)

As called for by the DFA, the regulatory implementation process is underway and has produced an overwhelming quantity of new regulations, most of which remain proposed rather than final

- The process started in August and September of last year
- Since then, it has produced thousands of pages of rule proposals

# Introduction

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Given the time allotted for this presentation, a comprehensive review of DFA Title VII is not feasible, other than in a superficial manner

Instead, this presentation will explore in depth selected topics under DFA Title VII that involve some of the more critical issues now being debated. With this in mind, this presentation will focus on key aspects of each of the following areas:

- Mandatory Clearing
- The “End-User” Exemption
- Ownership of Derivatives Clearing Organizations (DCOs)
- Market Structure and Swap Execution Facilities (SEFs)
- Capital and Margin for OTC swaps
- New Business Standards for OTC swaps
- Recordkeeping, Reporting, Confirmations and Documentation Requirements for OTC swaps

Note about terminology: The DFA/Title VII creates roughly parallel regimes for the CFTC (for swaps) and the SEC (for security-based swaps). For convenience, we will use the terminology from the CFTC’s domain to cover both of these regimes in this discussion.

# Mandatory Clearing

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How will the “List” function?

- Under the DFA and its regulations, the regulators (CFTC/SEC) and Derivatives Clearing Organizations (“DCOs”) will engage in a bilateral process that is intended to identify those swaps that are required to be cleared
- The statute contemplates that this process will focus on individual swaps as well as categories, types and classes of swaps
- To date, there is no clear indication of what type of list will be generated by this bilateral process between the CFTC/SEC and the DCOs

# Mandatory Clearing

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Major concern for Swap Dealers and Major Swap Participants (MSPs) (two new regulated entities under the DFA/Title VII): **How clearly will this List delineate swaps that are subject to mandatory clearing from those that are not?**

Until we have some insight as to what the List will look like, this concern will prevail.

- Will the List only refer to specific swaps, rather than categories or types of swaps that meet general parameters?
- Will the CFTC/SEC provide any guidance regarding how to distinguish an OTC trade from a similar, but not identical, swap that is on the List?
- Will market participants be left to make this judgment on their own and if so what is the risk if in hindsight a regulator or counterparty claims that their judgment was wrong?

# Mandatory Clearing

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To illustrate the problem, consider swaps that are currently being cleared, such as those on ICE Trust

ICE Trust (and its affiliate) currently clear in the US and Europe about 70 index-based credit default swaps (CDS) and 190 single-name CDS.

- For index-based CDS, ICE Trust in the US clears CDS based on various CDX.NA indices or sub-indices from time to time published by Markit and meeting other standardized terms. For example, a currently listed index-based CDS is identified by the following and characteristics:

Name: CDX.NA.IG. HVOL.14

Index Family: HiVol

Tenor: 5Y

Index Series: 14

Index Version:1

Currency: USD

Date Clearing Commenced: 3/26/2009

Active: Yes

- ICE Trust's rules provide for other standardized terms

# Mandatory Clearing

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- For single-name CDS, ICE Trust covers many major corporations, with a current example identified as follows:

Reference Entity: AT&T

Sector: Telecommunications

Coupon: 100

Tenor: OM-10Year

Market Ticker: ATTINC

Currency: USD

First Week Cleared: 1 Feb 10

Tier: SNRFOR

Also ISINs for reference obligations, including a preferred ISIN are specified and ICE Trust's rules provide for other standardized terms

- How will the List that is finally promulgated compare to these examples. In both cases, it is easy to imagine bespoke transactions that vary in significant and minor ways from these currently listed trades.
- How will market participants know with certainty whether what they believe to be a bespoke transaction under discussion is not subject to being deemed to within the ambit of a swap or category or type of swap on the List?

# Mandatory Clearing

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## How will margin segregation be implemented at the DCOs?

- The DFA requires that
  - DCOs ensure that: “nondefaulting members or participants would not be exposed to losses that nondefaulting members or participants cannot anticipate or control”
  - FCMs treat any property received as margin from a customer as belonging to that customer
- As a result, current margin regime used by FCM clearing members for futures is unlikely to satisfy DFA requirements for DCOs
- Regulators identified four models for maintaining customer margin:
  - Futures Model: All margin of a clearing member’s customers held in an omnibus account (loss mutualization)
  - Full Physical Segregation: Each customer’s margin separately accounted for
  - Legal Segregation with Commingling: all margin of a clearing member’s customers held in an omnibus account but attributed to each customer and adjusted on a pro rata basis if margin is insufficient due to market fluctuations in the value of the collateral
  - Modified Legal Segregation: may be similar to above, but also protect nondefaulting customer by placing it at bottom of collateral application waterfall

# Mandatory Clearing

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Issues currently under debate regarding segregating customer margin:

- What does the DFA mandate? It would certainly appear that the Futures model does not meet the new statutory requirements
- How expensive will new margin segregation requirements be for market participants? Several points are being debated:
  - Some contend that the greater the degree of segregation, the greater the cost of maintaining margin and that this greater cost will result in reduced overall liquidity in the market.
    - The validity of this concern is a major point of contention
    - Some of the existing clearing organizations already claim to be complying or in a position to comply with a Legal Segregation with Commingling model
- Relative cost of DCO margin segregation needs to be evaluated in light of the DFA's provision that allows end-users to require that any initial margin they post on an OTC swap be held at a third party custodian
- Achieving portability: The regulators' focus has been on preserving customer collateral from outside risks. However, as market participants have noted (including ISDA in a recent comment letter), achieving this goal without also assuring portability for customer margin and positions is an incomplete result. To fully protect customers, there also needs to be a mechanism upon failure of its FCM for a customer to post variation margin and thereby avoid having its positions liquidated

# End-User Exemption

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Since the DFA's enactment, both members of Congress and regulators have generally tried to assure end-user community that end-users will continue to be able to execute customized or bespoke swaps for hedging purposes without additional margin and capital requirements

- Confusion occurred due to absence of expected clarifying wording in final bill
- However, sharp push back from commercial end user community has prompted reassurances from regulators that will in all likelihood become formalized in any final regulations
- Thus, a party that meets the statutory criteria for being an "end-user" (this term is not actually used in the DFA), should retain flexibility to execute OTC swaps and thus avoid, if it so chooses, clearing, exchange execution, and margining on a DCO

# End-User Exemption

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Despite these assurances, significant lingering concerns remain regarding whether the end-user exemption will provide market participants with the relief intended

One concern is that, because of the additional clearing, margin and capital requirements facing non-end users (particularly swap dealers), customized and bespoke OTC swaps will be less available, harder to execute, with less attractive pricing and additional margin and other costs.

- In other words, though clearing, margining and capital may not mandatorily apply directly to an end-user, they will nevertheless feel the effects of these aspects of DFA/Title VII as they ripple through the market place
- In particular, swap dealers active in the OTC market will need to factor into their bespoke transactions the impact of these (and many other requirements of Title VII) which impact the swap dealer's cost, execution risk and ongoing risk management.

# End-User Exemption

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Another concern is that the “end-user” category at a statutory level has been defined too narrowly and that regulators may not have the inclination or even the authority to correct this situation

- This problem arises because:
  - Among the qualifications for being an “end-user” is that such party not be a “financial entity” as defined in relevant section of the DFA. As defined, financial entity includes:
    - swap dealers
    - major swap participants (MSPs)
    - commodity pools
    - private funds
    - ERISA plans
    - other entities predominantly engaged in banking business
  - DFA/Title VII narrowly defines that authority of the CFTC/SEC to either grant exemptions or modify definitions so as to narrow their application, thus raising questions as to whether, even if the regulators were inclined to address this concern, they would have the regulatory prerogative to do so

# End-User Exemption

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- To illustrate the problem, consider a large entity that is a swap dealer and otherwise engaged in the banking business and therefore is a “financial entity”. It would not be able to invoke the end-user exemption and thus could only execute non-cleared swaps if the swaps in question were not on the List (which, as noted, may if unclear or imprecise complicate the judgment facing such a party)
  - As with any other large entity, it may prefer to execute OTC swaps for a host of reasons having nothing to do with its activities as a swap dealer. As might be the case with an industrial company, a financial company (particularly its treasury group) may wish to execute OTC swaps to hedge its:
    - interest rate exposure on the debt it issues
    - exchange rate exposure to foreign currency based revenues or expenses
    - equity linked issuance obligations under (and the potential dilution resulting from) an equity based compensation plan
  - Why a financial entity should face any greater impediments to executing such OTC swaps for the same prudent reasons that would motivate a non-financial company is hard to fathom, yet this appears to be the arbitrary result under the DFA

# End-User Exemption

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- Whether this imbalance can and will be redressed is unclear
  - One concept relating to swap dealers is whether (as suggested by the current proposed rule) a “limited purpose designation” could be used to separate the swap dealing activities of an entity from its non-dealing (e.g., treasury) activities.
    - While a trading desk would be regulated as a swap dealer, the treasury group could stand apart and act as any other end-user
    - Presumably, some internal walls and communication protocols would be required to satisfy the regulators in this point
  - But for many entities, even a limited purpose designation might not be enough given the broad scope of the financial entity definition
    - Such a designation only helps with the swap dealer subcategory. If such entity is generally engaged in the business of banking then, even if it can avoid the swap dealer label, it will still be considered a financial entity ineligible to use the end-user exemption
    - The limited capacity of the CFTC/SEC to grant exemptions or otherwise narrowly interpret these provisions makes a solution even harder to achieve

# End-User Exemption

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A final concern in this area is that end-users attend to various procedural requirements (some of which arguably create unnecessary risk of an entity jeopardizing its exemption). These include:

- For public companies, a requirement that an appropriate committee of the board of directors review and approve of the company's decision to enter into swaps that are subject to exemptions from the mandatory clearing and exchange trading requirements
- For all end-users, a requirement that they provide (or cause to be provided) to a swap data repository (or, if none, the CFTC) the following information:
  - Electing end-user's identity and whether it is a financial entity or finance affiliate
  - Whether the swap is used by it to hedge or mitigate commercial risk
  - Whether it generally expects to meet its financial obligations associated with its uncleared swap by using a CSA, pledged or segregated assets (including margin), a third-party guarantee, solely its own financial resources, or other means
  - Whether it is a public company. If so, it also must provide its SEC Central Index Key number and whether the appropriate committee has reviewed and approved the decision not to clear the swap

# Ownership of DCOs

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The ownership and control of DCOs, and the potential for conflicts of interest arising for a party that both controls a DCO and is active in the swaps market, has led to an intense focus on this issue in the regulatory process

- The regulators response in their proposed rules has been:
  - For the CFTC, to set forth two alternatives
    - One would prohibit any member (and related parties) from owning more than 20% voting equity in a DCO, while also limiting all enumerated entities (such as banks, other financial companies, swap dealers and MSPs) from owning in the aggregate more than 40% voting equity in a DCO
    - The other would have no aggregate limit, but would limit each member (and related parties) to 5% voting equity
    - In addition, the CFTC proposed that a DCO could not set the minimum capital requirement for being a clearing member at about \$50 million
  - The SEC has proposed similar alternatives, though the 40% and 5% limits would apply to a narrower category of entities than they do in the CFTC's proposal
  - In both cases, governance requirements, including for independent directors and composition of board committees, would also be imposed

# Ownership of DCOs

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- Reaction to these rules have come from all directions
  - Antitrust Division of U.S. Justice Department to the surprise of many submitted a comment letter in late December 2010 calling for even tougher ownership limits, expressing concern that a small number of entities could dominate a DCO to block other entities having access to the platform or to limit the instruments that are accepted for clearing
  - By contrast, major industry participants, such as ICE, have expressed concerns that the proposed ownership limits are unduly narrow. These entities have argued that, to achieve an appropriate balance between the desire to expand ownership and participation in DCOs and exchanges and the need to preserve the financial strength and risk management focus of DCOs and exchanges, such organization should have greater freedom to determine
    - the composition and requirements for being an owner and/or member of a DCO or an exchange
    - which parties can serve on key risk management committees and subcommittees (ICE Trust, for example, currently requires members have at least \$1 billions in net capital in contrast to the \$50 million level proposed by the CFTC)
  - In the midst of the growing controversy in this area, ICE withdrew its pending application for DCO status (though under the DFA ICE Trust will in any event automatically become a DCO even without formal application). As a further indicator, the SEC recently announced that it was reopening the comment period relating to its proposed rule.

# Market Structure and SEFs

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Swap Execution Facilities (“SEFs”), a new trading platform contemplated by the DFA, will likely have a significant impact on how the structure of the swaps market evolves in the near future.

- SEFs, depending upon the form they ultimately take, can represent a bridge between the traditional exchange traded futures market and the pure bilateral OTC market
- At this stage, the regulators and the industry are engaging in a debate over how SEFs are to be structured and function

The DFA provided general guidance regarding SEFs by defining them to be more than a limit order based trading system. However, just how much more is the question that is now under debate

# Market Structure and SEFs

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- In its rule proposal, the CFTC has suggested a SEF model under which a SEF must
  - offer trading services to facilitate transactions executed on an Order Book or Request for Quote System, and
  - in its Request for Quote System, require a participant to transmit a request for a quote to buy or sell a specific instrument to no less than five market participants
- In the CFTC's rule proposal, CFTC Commissioner Jill Sommers dissented and offered her alternative SEF model that, in her view, is consistent with the Congressional intent that SEFs be broadly defined. Under Sommers' model for a SEF
  - it is clear that the SEF would not have to offer any Order Book execution and
  - a SEF can maintain a Request for Quote System under which participants may transmit a request to buy or sell a specific instrument to all other participants or to more than one potential counterparty or view real-time streaming quotes with the option to complete a transaction by accepting a firm streaming quote or transmitting a request for a quote to more than one market participant. Also any other trading system may be used as permitted by the CFTC
- The SEC's rule proposal appears closer to Sommers' in that it would permit a system or platform that allows more than one participant to interact with the trading interest of more than one other participant on that system or platform

# Market Structure and SEFs

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As this part of the regulatory process comes to a resolution, the structure of the swaps market may be greatly affected by:

- the extent to which the SEF model adopted permits a party to in effect execute a bilateral transaction with one or a very select number of potential counterparties via the electronic or voice media of the SEF
- the extent to which the SEF models adopted by the CFTC and the SEC are brought into alignment or have different characteristics, as this is not an area under the DFA where the two agencies are required to issue identical or joint rules

# Capital and Margin for OTC Swaps

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The DFA calls for bank regulators, as well as the CFTC and the SEC, to establish margin and capital requirements for the activities of swap dealers and MSPs

- Bank regulators are charged with doing so for those swap dealers and MSPs they regulate
- The CFTC and SEC have this role for non-bank swap dealers and MSPs
- Bank regulators are supposed to act in consultation with the CFTC and the SEC

To date, no rule proposals have been made in this area, which remains one of the few that is as yet unaddressed

- The required interagency consultation has, some speculate, made this process more challenging

# Capital and Margin for OTC Swaps

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Beyond the difficulty of coordinating a multi-agency response, other issues have made developing regulations for this area challenging

- Although it seems clear that margin requirements will only be imposed on swap dealers and MSPs (and not end-users), many suspect that by imposing these requirements on swap dealers and MSPs the regulations will cause a ripple effect resulting in greater cost, less availability, worse execution and reduced liquidity for end-users wishing to access the OTC swaps market.
- Interestingly, in his February 17<sup>th</sup> Senate testimony, CFTC Commissioner Gensler stated:

*“Interconnectedness among financial entities allows one entity’s failure to cause uncertainty and possible runs on the funding of other financial entities, which can spread risk and economic harm throughout the economy. Consistent with this, proposed rules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve non-financial end-users.”*

This statement seems to be an effort by Gensler to suggest that the CFTC can confine the impact of these regulations to the non-end user world, though precisely how that would be done (without an indirect impact on end-users) is not apparent

# Capital and Margin for OTC Swaps

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As to capital requirements, it is not at all clear how these OTC specific capital requirements are expected to interact with the broad entity (and holding company) wide capital requirements that already exist and apply to OTC transactions.

- It may be that uncertainty over whether and how these requirements overlap with Basel III or the Fed's regulation of BHCs accounts for the slow pace of rulemaking in this area

# Business Conduct Standards

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As required by the DFA, new business conduct standards for swap dealers and MSPs are being proposed by the CFTC and the SEC

- The rules touch on a host of topics, including “know-your-customer” standards, front running prohibitions, risk disclosure requirements (and scenario analyses), valuation and daily mark availability and heightened standards of conduct when dealing with Special Entities (pension plans, endowments, federal agencies and other political subdivisions, including municipalities)
- At a minimum, both swap dealers and MSPs face additional costs and operating burdens in their effort to comply with the new DFA business conduct standards
- In addition, both industry participants and even some segments of the end-user community (for whose benefit these new standards were intended) have expressed concerns, fearing that if these new standards are too burdensome the end-user community will find that it is harder for them to arrange and execute bespoke OTC swap transactions
  - For example, a group representing not for-profit electricity end users (including many municipalities) commented that they could be disadvantaged unless swaps relating to electricity were exempted from additional duties imposed on dealing with Special Entities

# Employee and Director Hedging

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The SEC must adopt rules requiring disclosure by public companies of whether any employee or director (or designee of such persons) is permitted to purchase financial instruments, such as prepaid variable forwards, equity swaps, collars, and exchange funds, that are designed to hedge or offset any decrease in the market value of equity securities granted as compensation or held directly or indirectly by the employee or director.

The SEC has not yet adopted these rules, and is currently not scheduled to propose the rules until August – December 2011.

# Recordkeeping, Reporting, Confirmations and Documentation

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In seeking to implement the DFA's mandate, the CFTC and SEC have in their proposed rules called for a vastly expanded regime of recordkeeping, data reporting, confirmation requirements and documentation standards

These requirements, as now proposed, include, among other things, daily trading records (including pre-trade, execution, and post-trade information), reporting of swap data to swap data repositories, pre-trade acknowledgments specifying all swap terms (other than price and other terms agreed on trade date), tight deadlines for post-trade execution of confirmations (ranging from 15 minutes to 24 hours), and swap trading relationship documentation (including credit support arrangements) executed prior to or contemporaneously with a trade.

These proposed requirements have caused tremendous concern within the financial community ranging from the feasibility of implementing some of the more daunting ones to the costs and timing associated with implementing whatever ends up in the final rules. Issues receiving the most debate include:

- By imposing such burdensome requirements, have the regulators inadvertently given an advantage to the larger institutions who in reality will be better able to complete required systems development and upgrades within any required timeframe and hence achieve a first mover advantage
- Should the CFTC/SEC use staged or staggered implementation to help ease the cost burden and level the playing field
- Should different types of entities have different compliance deadlines, though this suggestion also could advantage larger entities if they are forced to comply earlier

# Conclusion

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Although the DFA anticipated that much of the final regulatory structure for Title VII was to be in place by July 2011, it now appears likely that this target date will be missed for many of the ongoing rulemakings.

In addition, many market participants have begun to call for a more general and broad-based delay in the Title VII rulemaking process

- Many have noted that it is difficult, if not impossible, to comment on any one rule unless the other rules that could relate to it are also available for consideration. The uneven process at which this vast rulemaking endeavor has proceeded undermines the ability of interested parties to provide fully informed comments
- Others have observed that it is now apparent, given the unparalleled complexity of this rulemaking endeavor, that more time is needed and the process should be delayed and that acknowledging this reality is far more important for the regulation of the financial services industry than meeting overly-optimistic deadlines that were established without the benefit of the experience that we now have had.