

The Dodd-Frank Act and Derivatives A First Anniversary Review

July 21, 2011

Peter Green, Morrison & Foerster LLP
Richard Grove, Rutter Associates LLC
David Kaufman, Morrison & Foerster LLP



RUTTER ASSOCIATES LLC

60 East 42nd Street, Suite 2816 New York, NY 10165
Telephone: (212) 949-1180 Fax: (212) 949-1249

MORRISON | FOERSTER

Introduction and Overview

- At the one year anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “DFA”), what is the status of the regulatory reform of the swaps market contemplated by Title VII of the DFA?
- This presentation will assess the current status of the Title VII regulatory process by
 - Reviewing the key rulemaking initiatives that are in process under Title VII
 - Considering the major issues and potential concerns that have been raised regarding these rulemaking initiatives
 - Discussing the consequences for the swaps market that may result from the implementation of the various rule making initiatives
 - Comparing aspects of the new Title VII regulations to the European Market Infrastructure Regulation (“EMIR”) that, once finalized, will regulate swaps activity in the EU

Introduction and Overview

- Unless otherwise provided in Title VII, the CFTC and SEC are required to promulgate rules required of them under Title VII no later than July 16, 2011
 - This deadline generally has not been met
- CFTC
 - Approximately 50 proposed rules
 - 10 final rules (as of July 19)
 - 2 interim final rules
 - 2 studies
- SEC
 - 13 proposed rules
 - Additional rulemaking still required (e.g., margin and capital requirements)
 - 1 final rule
 - 3 interim final rules
 - 1 study

Introduction and Overview

- Unless otherwise provided in Title VII, the provisions of Title VII become effective on the later of July 16, 2011 or, to the extent a provision requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provision
- In order to avoid widespread uncertainty in the derivatives markets as to which provisions of Title VII would become effective on July 16, 2011, the CFTC and SEC separately issued temporary exemptive orders (and related no-action relief) in July that, in effect, defer most Title VII requirements.
 - The temporary exemptions do not, however, limit the agencies' antifraud or antimanipulation authority with respect to swaps and security-based swaps, which became effective on July 16, 2011

Note: 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.

Definitions

Swaps

Swaps: What's included and what's excluded?

- Addressed in Joint CFTC/SEC Rule Proposal (“Joint Swaps Proposal”) published in May
- In several cases, the Joint Swaps Proposal tries to clarify that certain types of transactions will not be considered Swaps, including:
 - Commodity forwards
 - Security forwards
 - Consumer and commercial contracts
 - Insurance products
 - Loan participations
 - RTO and ISO transactions in the energy markets
 - Non-swaps documented under industry standard master agreements

Swaps

- Some of these clarifications are more helpful than others
 - Joint Swaps Proposal's discussion of Commodity Forwards and Security Forwards is helpful in confirming the non-swap status of these transactions
 - Insurance Products are to be distinguished from swaps based on a multi-pronged test involving the characteristics of the contract (must have an insurable interest and limit claim to actual damages), the type of entity (must be a regulated insurer or reinsurer) and the absence of secondary trading (can't trade product separately from insurable interest on an organized exchange or market).
 - Additional requirements are proposed to distinguish financial guaranty insurance from CDS
 - Various traditional insurance products would be excluded
 - Treatment of a financial guarantor's wrap of a swap not clear
 - Overall anti-evasion concern pervades the discussion of Insurance Products
 - The approach to Loan Participations has created concern as it excludes "true-sale" loan participations, but not non-true sale "risk" participations, from the swap definition

FX

- FX Transactions: remains a confusing area
 - As permitted by the DFA, the U.S. Treasury appears likely to exempt “foreign exchange forwards” and “foreign exchange swaps”. These terms, however, are narrowly defined and thus do not include many types of FX transactions that would otherwise fall within the Swaps definition
 - Joint Swaps Proposal confirms that any transaction exempted by the Treasury would still be subject to the swap reporting and business conduct standards under DFA/Title VII
 - Joint Swaps Proposal also confirms that various other non-exempted FX transactions will be within the Swaps definition. These include:
 - FX options
 - Non-deliverable FX forwards
 - Currency swaps and cross-currency swaps (these are not under the Treasury’s exemption because they involve contingent or variable payments, rather than having a fixed nonvariable exchange rate)
 - Retail FX Transactions remain subject to a separate regulatory regime under the Commodity Exchange Act and implementing regulations by various applicable regulatory agencies

Title VII Definitions Versus EMIR

- How does scope of EMIR compare to the DFA?
- EMIR is likely to be very similar in scope to DF in relation to derivatives but some issues remain unresolved:
 - FX derivatives are generally within scope of EMIR (except spot FX and commercial forwards) but it is not clear if ESMA will specify them to be subject to a clearing requirement
 - Major unresolved issue is whether EMIR should apply only to OTC derivatives or all derivatives including those that are exchange traded
 - No distinction in EMIR between security based swaps and other swaps
 - Pension funds likely to be excluded from EMIR for at least a specified period

Swap Dealers

Swap Dealers: Which entities will be covered by this definition?

- As defined in the DFA, a swap dealer is a person who:
 - (1) holds itself out as a dealer in swaps or security-based swaps, (2) makes a market in swaps, (3) regularly enters into swaps with counterparties as an ordinary course of business for its own account, or (4) engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps
- Meeting any one of these functional tests is sufficient to be categorized as a swap dealer
- However, under the DFA, swap dealer does not include a person that enters into swaps “for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.”
- The DFA contemplates that (1) this definition will be refined by CFTC/SEC, (2) swap dealer registration can be limited by activity or swap category and (3) exceptions will be provided for de minimis activities and for insured depository institutions to the extent they execute swaps in connection with loan originations
- CFTC/SEC addressed swap dealer (and major swap participant) definitions in joint rule proposal issued in December 2010 (“Joint Dealer/MSP Proposal”)

Swap Dealers

- In Joint Dealer/MSP Proposal, CFTC and SEC largely rejected many industry suggestions that more precise criteria be used to identify swap dealers.
- Instead, Joint Dealer/MSP Proposal identified and elaborated on the following characteristics to be used in applying swap dealer definition:
 - Accommodating demand from other parties
 - General availability to execute swaps to facilitate other parties' interests
 - Tending to execute swaps on own standard terms or other terms proposed in response to counterparties
 - Ability to arrange customized terms or develop new products
- Additional separate criteria for security-based swap dealers were also proposed

Swap Dealers

- Looking to identify those parties “whose function is to serve as the points of connection” in the swap markets and therefore will look at these parties functionally rather than based on narrowly specified criteria
- The regulators acknowledge particular industry concern over how to identify a person who “**regularly enters into swaps with counterparties as an ordinary course of business for its own account**”, noting that
 - The DFA also has an exception for those whose activities are not “**part of a regular business**”
 - The presence or absence of a “regular business” should be considered in applying the above functional test
- For Security-based Swap Dealers, the traditional factors used to identify “dealers” under the Securities Exchange Act of 1934 shall also be applied, including
 - The “dealer” vs. “trader” distinction that has historically existed under the 1934 Act
 - Though not dispositive, dealers tend to have clientele and inventory, provide liquidity and hold themselves out to the market

Swap Dealers

- Joint Dealer/MSP Proposal rejects that notion that the “market making” test requires a person to maintain continuous two-sided activity in the swaps market in order to be deemed a dealer
- Joint Dealer/MSP Proposal offered what many view as a very limited “de minimis” exception, in which an entity must satisfy all of the following conditions:
 - the swap positions into which the entity enters during the immediately preceding 12 months have an aggregate gross notional amount of no more than \$100 million (or \$25 million with regard to “special entity” counterparties, which consist of Federal agencies; States, State agencies, and political subdivisions; ERISA and governmental plans; and endowments),
 - the entity has not entered into swaps in connection with its swap dealing activities (presumably by major swap category) with more than 15 non-swap dealers during the immediately preceding 12 months, and
 - the person has not entered into more than 20 swaps in connection with those activities during the immediately preceding 12 months.

Swap Dealers

- The Joint Dealer/MSP Proposal seeks to clarify the exclusion of swaps executed in connection with loans in several respects
 - The rate, asset, liability, or other notional item underlying the swap would have to be, or be directly related to, a financial term of the loan
 - An insured depository institution will be considered to have originated a loan if it, among other things, directly transfers the loan amount to the customer, is part of a syndicate of lenders for the loan, or purchases or receives a participation in the loan
 - However, no clarification was provided as to whether this exclusion might apply to uninsured branches and agencies of foreign banks, though one comment has been made seeking this clarification
- Under the Joint Dealer/MSP Proposal rules, an entity may limit its designation as a swap dealer and security-based swap dealer to specified categories of swaps or specified activities of the person in connection with swaps
 - For example, an entity might be a swap dealer for rate-based swaps, but not for commodity-based swaps
 - Also, the proposed rules suggest that the swap dealer designation could be limited to a distinct division of an entity (such as an identifiable trading group)
 - How these limitations will work in practice remains unclear and further guidance will be needed from the regulators on these matters
 - Rule proposal suggests that limited designations will need to be applied for and approved by the regulators

Swap Dealers

- Long list of significant issues relating to the swap dealer definition remain unresolved and have been focus of industry comments:
 - Functional definition is too vague
 - Bright line tests are needed, with an emphasis on two-way market activity and greater recognition of “dealer-trader” distinction
 - End-users have voiced concern over being inappropriately categorized as swap dealers
 - Small and medium sized insured banks are concerned because falling into swap dealer status could expose them to adverse consequences under Lincoln Provision (DFA Section 716)
 - Troublesome extraterritorial questions
 - How can a foreign entity with U.S. operations and U.S. swap counterparties confine its swap dealer status to those operations-this has become a major concern for large foreign banks with U.S. branches, particularly as they typically have booked their U.S. swaps to their head office or a non-U.S. branch
 - Might the swap dealer status of a U.S. entity apply extraterritorially to the offshore swap activities of affiliates, branches or subsidiaries of that U.S. entity

Swap Dealers

- Limited Swap Dealer designations:
 - A clear regulatory mechanism allowing an entity to register on a limited basis is needed
 - This might help address the extraterritorial issues noted above
 - Also might allow an entity to isolate a trading desk as a separate division, while preserving non-swap dealer status for the rest of an entity, including its treasury group where non-dealer hedging and risk management activities are executed
- Inter-affiliate transactions:
 - The regulators have asked whether, and commenters have urged them, to exclude these from the swap dealer determination (as well as other aspects of Title VII)
- De minimis exception is inadequate
 - Limits are too low and should be sized based on relevant market
 - Interaffiliate trades, hedges, offshore trades shouldn't count against limits
- Exclusion for swaps related to loan originations
 - See proposed regulation as unnecessarily restrictive
 - Offsetting trades should also be excluded to avoid inadvertently exceeding de minimis exception or MSP criteria

Major Swap Participants

Major Swap Participants (MSPs): Which entities are covered?

- The DFA provided the following three separate definitions of MSP:
An entity:
 - that maintains a “**substantial position**” in swaps for any of the major swap categories, excluding positions held for hedging or mitigating commercial risk or positions maintained by an employee benefit plan for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan,
 - 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 financial entity that (i) is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency and (ii) maintains a “**substantial position**” in outstanding swaps in any major swap category

Major Swap Participants

- In the Joint Dealer/MSP Proposal, the MSP definition was refined in various respects
 - “**Major swap categories**” are identified as rate swaps, credit swaps, equity swaps, and other commodity swaps; and “**major security-based swap categories**” are as security-based credit derivatives and other security-based swaps
 - “**Substantial position**” is defined based on both a current uncollateralized exposure test and a potential future exposure test, which is applied to each of the major swap categories. In general terms, a “substantial position” means swap positions that equal or exceed any of the following thresholds:
 - For Rate Swaps: (i) \$3 billion in daily average aggregate uncollateralized outward exposure; or (ii) \$6 billion in daily average aggregate uncollateralized outward exposure *plus* daily average aggregate potential outward exposure
 - For Credit Swaps, Equity Swaps, Other Commodity Swaps, and Major Categories of Security-Based Swaps: (i) \$1 billion in daily average aggregate uncollateralized outward exposure; or (ii) \$2 billion in daily average aggregate uncollateralized outward exposure *plus* daily average aggregate potential outward exposure
 - In applying these thresholds
 - “Aggregate uncollateralized outward exposure” is the mark-to-market exposure of all positions with a negative value, less the value of all collateral posted by the entity for those positions, and
 - Subject to certain adjustments, “aggregate potential outward exposure” is the product of the total notional amount of the positions and various multipliers based on product categories and whether the swaps are subject to daily mark-to-market margining or clearing

Major Swap Participants

- To determine a “**substantial counterparty exposure**,” the Joint Dealer/MSP Proposal uses the same two tests as for substantial position (i.e., the current uncollateralized exposure test and the potential future exposure test), but rather than applying these tests to a specific swap category, the tests are applied across all of an entity’s swap positions. In general terms, a “substantial counterparty exposure” means
 - a swap position that satisfies either of the following thresholds: (i) \$5 billion in daily average aggregate uncollateralized outward exposure; or (ii) \$8 billion in daily average aggregate uncollateralized outward exposure *plus* daily average aggregate potential outward exposure, or
 - a security-based swap position that satisfies either of the following thresholds: (i) \$2 billion in daily average aggregate uncollateralized outward exposure; or (ii) \$4 billion in daily average aggregate uncollateralized outward exposure *plus* daily average aggregate potential outward exposure

Major Swap Participants

- The Joint Dealer/MSP Proposal seeks to clarify those swap positions to be excluded from the “substantial position” test because they are considered to be held for the purpose of “hedging or mitigating commercial risk.” On this point, the CFTC and SEC proposals contain some differences, including:
 - The CFTC version would exclude positions that qualify for the bona fide hedging exemption from position limits under the Commodity Exchange Act or that qualify for hedging treatment under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133)
 - The SEC version would require the person relying on the exclusion to identify and document the risks that are being reduced by the security-based swap position, establish and document a method of assessing the effectiveness of the security-based swap as a hedge, and regularly assess the effectiveness of the security-based swap as a hedge
- For “highly leveraged,” the CFTC and the SEC proposed using the ratio of an entity’s total liabilities to equity, measured at the close of business on the last business day of the relevant fiscal quarter. However, the rule proposals ask for comment on whether the threshold ratio should be set at 8:1 or 15:1

Major Swap Participants

- Timing Considerations:
 - Not deemed to be an MSP until the earlier of (i) the date on which the person submits a complete application to register as an MSP or (ii) two months after the end of the quarter in which the person meets the MSP definition.
 - Reevaluation Period: If a person not registered as an MSP meets the definition in a fiscal quarter *but doesn't exceed any applicable threshold by more than 20%*, the person will become subject to the registration timing described above at the end of the next fiscal quarter *if* the person exceeds any of the applicable daily average thresholds in that next fiscal quarter
 - Termination of MSP Status: An MSP will continue to be deemed an MSP until such time as its swap activities do not exceed any of the daily average thresholds for four consecutive fiscal quarters after the date on which it becomes registered

Major Swap Participants

- Because of its quantitative basis, the MSP rule proposal has prompted a different set of concerns than the swap dealer rule proposal, such as
 - Should registered investment companies be exempt from MSP registration requirements
 - How can the ongoing calculation burden be eased, particularly for those entities that are close to the MSP thresholds
 - Can the hedge exceptions be further clarified and reconciled between the CFTC and SEC proposals
 - What constitutes “commercial risk” for purposes of applying the hedge exception
- Overall, this debate has been much more technical in nature than the corresponding discussions relating to the swap dealer definition

Business Conduct Standards

New Business Conduct Standards

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

New 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
- Comparison to EMIR
 - EMIR does not provide for regulation of swap dealers or major swap participants (or equivalent):
 - parties engaging in derivatives dealing are already subject to regulation under MiFID
 - MiFID currently subject to review which likely will extend obligations relating to derivatives

Clearing

Clearing Requirements

- **Basic Statutory Requirement:** A “swap” must be cleared if the applicable regulator determines that it is required to be cleared, unless
 - There is no derivatives clearing organization (“DCO”) that accepts that swap for clearing; or
 - One party to that swap is a “commercial end-user” that elects not to have the swap cleared
- **Before this basic clearing requirement can be implemented**
 - Final rules must be in place to establish the process for determining those swaps subject to mandatory clearing-these rules were adopted on July 19, 2011
 - Now that final rules are in place, the regulators and the DCOs must undertake determination process, the initial phase of which might extend over a considerable time period
- **CFTC/SEC are to look at five broad factors in determining whether a swap should be cleared:**
 - The notional exposures, trading liquidity and adequate pricing data
 - The available rules, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on its current material trading terms
 - The effect on systemic risk mitigation, considering market size of the market and DCO resources
 - The effect on competition
 - The legal certainty relating to DCO and clearing member insolvencies

Clearing Requirements

- The Determination Process: On July 19, 2011, the CFTC adopted final rules implementing the DFA's clearing requirement. The SEC has issued proposed rules on this topic. In both cases, the rules closely track the statutory framework, by providing that:
 - A determination can be made for any single swap, or any group, category, type, or class of swaps
 - The determination process can be initiated in one of two ways-either:
 - CFTC/SEC may initiate review (this will be an ongoing process with the regulators), or
 - a DCO may initiate review by submitting to the applicable regulator each swap (or group, category, type, or class of swaps) that it plans to accept for clearing
 - In either case, the expectation is that the CFTC/SEC and the DCOs will engage in a bilateral process that is intended to identify those swaps that are required to be cleared
 - Once initiated, certain review and comment periods will apply:
 - If initiated by CFTC/SEC, the regulators must provide at least 30-day public comment period and make a determination within 90 days
 - If initiated by a DCO, applicable regulator generally must make a determination within 90 days, but a counterparty may seek a stay and an additional 90 day review of this determination

Clearing Requirements

- What will the determination process yield?
 - All swaps that are currently being cleared will in all likelihood be listed as swaps required to be cleared. Such swaps are deemed automatically subject to review by the applicable regulators
 - Also, DCOs will be presumed to be able to accept for clearing any swap that is in a category or class of swaps that it already clears
 - Nevertheless, as will be discussed later, the content and clarity of the list of swaps and types and categories of swaps that must be cleared continues to be an unknown
- If the regulators determine that a particular swap, group or category is to be cleared, but no DCO accepts it for clearing, then the regulator can investigate, issue a report within 30 days, and "take such action as determines to be necessary" including imposing margin and capital requirements

Clearing Requirements

- The so-called “Commercial End-User” exception (not a defined term under the DFA)
 - Even if a swap is required to be cleared and is accepted for clearing on a DCO, the clearing requirement will not apply if one of the parties
 - Is not a “financial entity” (a financial entity is a swap dealer, major swap participant, commodity pool, private fund, ERISA plan, or person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature);
 - Is using swaps to hedge or mitigate commercial risk; and
 - Notifies the applicable regulator how it generally meets its financial obligations associated with entering into non-cleared swaps
 - *Note—Application of the clearing exception is solely at the discretion of the commercial hedging entity*
- If an end-user opts to have a trade cleared, it also has the right to select the DCO that will be used to clear the trade

Clearing Requirements

- An in depth discussion of the “commercial end-user” exception is beyond the scope of this presentation; however, it should be noted that this topic alone has generated a substantial list of comments and concerns from market and industry participants, which include:
 - What is the scope of this exception-i.e., does it truly exempt qualifying end users from any OTC margin and capital requirements?
 - Is the limitation of this exception to “non-financial entities” appropriate and, if not, given the statutory wording, is there anything that the regulators could do to address this point?
 - Given other definitional issues (such as the scope of the “swap dealer” definition), will entities be permitted to segregate internal operating divisions to preserve non-financial entity status for one division, while another is registered as a swap dealer?
 - Is the concept of “commercial risk” sufficiently clear? Note that in a different context--the rule proposal defining the term “major swap participant”--a definition of “hedging or mitigating commercial risk” is included

Clearing Requirements

- DCOs are required to register with their applicable regulator
 - Certain entities that are already registered as clearinghouses will automatically become DCOs when final regulations become effective
 - DCOs are required to operate in accordance with Core Principles enumerated in the DFA, including:
 - Financial Resources; Participant and Product Eligibility; Risk Management; Settlement Procedures; Treatment of Funds; Default Rules and Procedures; Rule Enforcement; System Safeguards; Reporting; Recordkeeping; Public Information; Information Sharing; Antitrust Considerations; Governance Fitness Standards; Conflicts of Interest; Composition of Boards; Legal risk.
 - DCOs, as will be discussed later, are subject to limitations and restrictions on ownership, membership and business conduct
 - The DFA amends certain aspect of the U.S. Bankruptcy Code to clarify the “safe harbor” status of cleared swaps
 - On July 15, 2011, ICE announced that on July 16th its credit default swap clearing house, ICE Trust U.S. would complete its transition to a CFTC regulated DCO (and SEC regulated clearing agency), operating under the name ICE Clear Credit

Clearing Requirements

- Full scale implementation of the DFA clearing regime faces a number of major hurdles:
 - One: Can the process be implemented without disrupting or impeding efficient and desired market activity? Commenters have repeatedly noted that to avoid creating instability at the DCO level, the process must take account of swap liquidity as mandatory clearing is brought into effect
 - Several commenters have called on the CFTC/SEC to stagger the implementation of the cleared swap determination process, arguing that a gradual approach is necessary to:
 - Allow the market time to invest in and test the infrastructure and systems required for margining,
 - Insure that adequate risk management processes are in place, and
 - Assess the sufficiency of, and where necessary develop, liquidity needed to support the mark-to-market margining required for the stability of ongoing DCO operations
 - Among the approaches suggested are to stagger the implementation of mandatory clearing by:
 - Asset class
 - Swap liquidity
 - Market participant

Clearing Requirements

- The general view is that credit and rate swaps are the asset classes most ready for clearing, while equity swaps are least ready with commodity swaps falling in between these two groups
- However, swap liquidity could dictate which swaps within a given asset class are truly ready for clearing (e.g., a highly bespoke CDS may never be appropriate for clearing, while a plain vanilla natural gas swap (some of which are cleared on futures exchanges today) might be suitable given its liquidity)
- The notion of staggering clearing by market participant is designed to, at first, limit clearing to those participants most able to do so from a systems and operational perspective
 - One idea was to start with swap dealers, then move to major swap participants and finally any other non-exempt market participants
 - However, this would tend to give swap dealers a first mover advantage in the market that might be a concern to non-dealer financial entities
- There remains significant concern that, without a graduated and staggered implementation process, the necessary infrastructure for clearing swaps and for having DCOs interact with the newly mandated Swap Execution Facilities (“SEFs”) will prove inadequate and as a result market activities will be disrupted

Clearing Requirements

- Two: Which swaps, or types or categories of swaps, will be identified through the determination process and what form will this identification take?
 - To date, there is no clear indication of the form this identification will take
 - Will it be a list of specific swaps or will it list types and categories of swaps?
 - If types or categories are listed, how will the parameters for these swaps be described?
 - Will the CFTC/SEC provide any guidance regarding how to distinguish an OTC trade from a similar, but not identical, swap or swap category/type that has been identified as subject to mandatory clearing?
 - 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?

Clearing Requirements

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

- Example 1: 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. a currently listed index-based CDS is identified by the following and characteristics:

Name: CDX.NA.IG. HVOL.14

Tenor: 5Y

Index Version:1

Date Clearing Commenced: 3/26/2009

Index Family: HiVol

Index Series: 14

Currency: USD

Active: Yes

- Example 2: For single-name CDS, ICE Trust covers many major corporations, with a current example identified as follows:

Reference Entity: AT&T

Coupon: 100

Markit Ticker: ATTINC

First Week Cleared: 1 Feb 10

Sector: Telecommunications

Tenor: OM-10Year

Currency: USD

Tier: SNRFOR

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

Clearing Requirements

- How will the swaps or swap categories/types finally identified by the regulatory determination process 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 designated for mandatory clearing?

Clearing Requirements

- Three: 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, the 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 Operational 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
 - The CFTC, in its April 2011 rule proposal, tentatively opted for “Legal Segregation with Commingling,” but signaled that it was not definitively wedded to this approach

Clearing Requirements

- The regulators and industry participants (sell-side, buy-side, DCOs and service providers) are debating the following issues:
 - What will be the increased cost and liquidity drain from the imposition of the DFA margin segregation requirements?
 - Presumably, 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
 - Some existing clearing organizations claim that they are well positioned to implement the legal segregation approach
 - Non-cleared OTC swaps may also, at end-user's election, have initial margin segregation, so the liquidity burden may differ little between cleared and uncleared trades
 - How much greater protection would Full Physical Segregation provide to clearing customers in comparison to Legal Segregation with Operational Commingling (LSOC)?
 - Buyside commenters have been quite vocal in their concern over being exposed to default risks of other customers or failing clearing members
 - Both buyside and DCO have noted that the LSOC method forces customers and DCOs to rely on clearing member account maintenance and recordkeeping, which could become problematic in stress scenarios

Clearing Requirements

- To what degree can portfolio margining and cross-DCO margining be achieved under new collateral segregation regime?
- Can full portability of customer accounts be achieved following clearing member default?
 - Segregating initial margin (whether under LSOC or Full Physical Segregation) is only part of the story
 - Additional regulatory and/or DCO requirements may be needed to ensure that a customer can move its account and related segregated margin to a new clearing member before its positions are closed out, including some ability to post variation margin until account transfer occurs

Clearing Requirements

- Four: What new documentation requirements will the market need to adopt in order to implement the new clearing regime?
 - Documentation will need to cover clearing (i) a bilaterally executed OTC swap (such as one done with an end-user) and (ii) a swap executed on a SEF or an exchange
 - Not clear that one set of documents can address both types of swaps
 - ISDA and FIA jointly published a Cleared Derivatives Execution Agreement (and related materials) designed for use with both swap categories
 - Bilateral swap documentation will need to take account of end-user's option to elect not to clear
 - SEF swap documentation will need to take account of SEF rules and membership agreements
 - In each case, give-up agreements must be developed to work in tandem with the execution documentation and will have to address:
 - Complex timing issues regarding affirmation of trade terms and submission of trades for clearing
 - Fallback procedures in the event that a DCO rejects a trade submitted for clearing
 - Position limits established by clearing members
 - Ensure the margin terms comply with DCO requirements
 - On July 19, 2011, CFTC proposed rules that would
 - Place limits on certain terms that FCMs, swap dealers and MSPs may include clearing documentation with customers
 - Impose time frames for DCOs and clearing members to accept or reject trades
 - Require FCMs, swap dealer and MSPs to establish credit and market risk-based limits relating to their clear member activities
 - Commissioners Summers and O'Malia viewed these as unnecessary proposals not called for by the DFA

Clearing Requirements

- Five: How will the final regulations limit or restrict the ownership of and membership in DCOs?
 - 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
 - Regulators have in their rule proposals suggested limits on ownership, limits on membership requirements and governance requirements, including for independent directors and composition of board committees
 - Some DCOs have criticized these limitations and requirements, arguing that to preserve the financial strength and risk management focus of DCOs, 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 subcommittee (ICE Trust, for example, currently requires members have at least \$1 billion in net capital in contrast to the \$50 million level proposed by the CFTC)

Clearing Requirements

- Six: How will the SEF model, as established in the final CFTC/SEC regulations, affect the implementation and development of the clearing requirements under the DFA?
 - Under the DFA, if a swap is required to be cleared, it must be executed on either an exchange (i.e., a futures exchange or securities exchange) or a SEF, unless
 - There is if no exchange or SEF that makes the swap “available to trade”; or
 - A “commercial end-user” elects to execute OTC
 - The DFA provides 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 between the regulators and major market participants
 - In particular, the extent to which SEF may be based on a “request for quote” (RFQ) system rather than a limit order book system has become a key point of contention among regulators and industry participants
 - Some argue that RFQ system must require solicitation of multiple bids, while others contend that solicitation of even a single bid should suffice
 - This question lead to one of the CFTC Commissioners, Jill Sommers, dissenting to the CFTC’s propose rule and offering her own alternative view on what type of RFQ structure should be permissible

Clearing Requirements

- The final SEF regulations will also need to establish the parameters for “block” trades that may be executed on a SEF, but outside of normal multi-lateral execution requirements
- The DFA also directs that the regulators require “open access” on DCOs so that all economically equivalent swaps can be cleared on a non-discriminatory basis
 - So all SEFs that trade equivalent swaps will need to be accorded equal access to DCOs that clear those swaps, along with any OTC trades that are also equivalent
- Whether a swap is in fact “available to trade” on an exchange or SEF is a question on which market participants have commented in the rulemaking process
 - Commenter have argued that “available to trade” should not merely mean listed on an exchange or a SEF
 - Instead, “available to trade” should mean that a particular swap has sufficient liquidity and market participation to justify mandating that it be executed through such a trading platform. Absent these characteristics, off exchange execution should remain an option to market participants, even if clearing is required
 - The CFTC and SEC have also been urged to establish clear quantitative standards by which to judge whether a swap is “available to trade” so as to avoid undue confusion at the point when parties wish to execute trades

Clearing Requirements

- The flexibility of the SEF environment (single bid RFQ vs. multi-bid RFQ/limit order book), the approved block trading parameters, the need to comply with the DFA's open access mandate and the development of "available to trade" criteria will ultimately dictate how much swap execution migrates to the SEF arena and that in turn will shape the extent of systems connectivity and contractual frameworks required to link SEFs with DCOs

Clearing Under EMIR

- Comparison to swap clearing under EMIR
 - In general, should be similar to what the DFA contemplates
 - However, a lot will depend upon which swaps ESMA determines will be cleared
 - There is a commercial hedging exemption which is similar to the end user exemption but non financials in the EU will not be required to clear any swap unless their swap positions exceed a clearing threshold (and commercial hedges are not included in calculating the threshold). However, once the clearing exemption is exceeded the entity must clear all swaps including its commercial hedges.
 - No provision for mandatory exchange trading under EMIR although this is envisaged under the MiFID review
 - Expectation (and hope) is that there will be some coordination with US authorities as there is considerable potential for problems/arbitrage if there are major differences

Margin and Capital Requirements

Margin and Capital Requirements

- The DFA calls for prudential regulators, as well as the CFTC and the SEC, to establish margin and capital requirements for uncleared swaps executed by swap dealers and MSPs
 - Prudential regulators (Fed, OCC, FDIC, Farm Credit Administration, and Fed Housing Finance Authority) 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
 - Prudential regulators are supposed to act in consultation with the CFTC and the SEC
- To date, the prudential regulators and the CFTC (but not the SEC) have issued proposed rules covering margin and capital relating to uncleared swaps

Margin and Capital Requirements

Margin

- Prudential regulator rule proposal provides that
 - Margin requirements vary depending upon the type of counterparty that a swap dealer or MSP has
 - Other swap dealer or MSP
 - High risk financial end-user
 - Low risk financial end-user
 - Non-financial end-user
 - “Financial End-User” is similar to the definition of “financial entity” used in the Title VII to define a commercial end-user, except it also includes non-U.S. sovereign counterparties (including central banks)
 - Initial Margin (IM) requirement can be based on either:
 - Standardized “lookup” table with margin levels based on notional amount and varying by asset classes, or
 - Internal model of swap dealer/MSP that has been approved by prudential regulator and meets specified requirements, including:
 - Calculating IM sufficient to cover “potential future exposure”
 - Limiting position netting in various respects, including by asset class
 - Monthly recalibration
 - Benchmarking to be no less than DCO requirements based on observable DCO standards

Margin and Capital Requirements

- IM threshold may only be used for low risk financial end-user and non-financial end-user
 - For low risk financial end-user, prudential regulators intend to specify maximum thresholds in final rule, but offered proposed ranges for commenter to consider
 - For non-financial end-user, proposal does not place a specific limit on maximum threshold, but would require margin to be collected whenever thresholds are exceeded
- Similar threshold structure is proposed for variation margin (VM) requirements
- Eligible collateral consists only of cash, U.S. Treasuries and, for IM only, agency obligations, with haircuts for all non-cash items
- IM between swap entities (swap dealers and MSPs) required to be held at independent third party custodian located in same insolvency jurisdiction as swap entity providing collateral
- Margin requirements would apply to some offshore transactions executed by branches of or companies controlled by U.S. companies

Margin and Capital Requirements

- CFTC's proposed rule is similar in many respects to the prudential regulators' proposal. However, key differences exist, such as
 - No explicit margin requirement (including threshold limits) for non-financial end-users, though credit support arrangement must be in place addressing margin requirements and collateral eligibility and valuation
 - IM calculations must be based on an existing DCO model, a model from a licensed vendor or a model used by an entity subject to regular assessment by a prudential regulator
 - Alternatively, can use a model that will be specified in the final rule—as proposed, the alternative model relies on multiples of margin levels applied by DCOs to comparable cleared swaps or futures
 - For non-financial end-users, eligible collateral can include any asset for which value can be reasonably ascertained on a periodic basis
 - IM provided by a swap entity is subject to similar requirement for an independent custodian, but proposal adds further prohibition on any rehypothecation or reinvesting of such IM
 - No extra-territorial guidance such as that provided in prudential regulators' proposal

Margin and Capital Requirements

- These proposed rules have raised a substantial list of significant issues, many of which have been the subject of comments by industry participants, including:
 - Why should differing margin regimes exist (particularly given DFA's requirement for consultation between the regulators)?
 - Exemption of end-users from margin requirements is not sufficient
 - Prudential regulators provide no exemption (unless an infinite threshold is established)
 - CFTC appears to provide an exemption, but mandates credit support documentation nonetheless (end-users want freedom and discretion to negotiate these documents)
 - Remove distinction between financial and non-financial end-users
 - Under prudential regulators' proposal, financial end-user definition is overly broad and should not cover sovereigns, SPVs, state/local agencies, pension plans
 - EMIR appears to exclude sovereigns from swaps it covers
 - Extra-territorial impact should be clarified under both proposals and narrowed from its current form under the prudential regulators' proposal
 - Prudential regulators should permit netting across asset classes and between IM and VM
 - Benefit of "master netting agreement" should be more clearly recognized and netting should be permitted between swaps and other non-swap derivatives

Margin and Capital Requirements

- Prudential regulators should permit non-cash margin for end-users (as DFA contemplates)
- Margin segregation requirements are overly broad and requirement for “independent” custodian is not appropriate (except for end-user IM as mandated by DFA), as is requirement for locating custodian in same insolvency jurisdiction as posting party
- CFTC proposal should permit proprietary/internal models, subject to approval
- Exception should be available for SPV securitization transactions (which are often collateralized by the structure itself and bankruptcy remote SPV)
- Exception should be available for inter-affiliate transactions (with BHCs, FRA sections 23A/B otherwise address these)
- Swap dealers and MSP should have greater flexibility in determining margin thresholds and the timing and frequency of margin postings
 - IM requirement based on 99% confidence level over 10 day horizon is too burdensome (3-5 day horizons are common on DCOs)
- Small financial institutions should be treated as a non-financial end-user
- Margin lending arrangements may be of limited value in helping end-users address new requirements
- Phase in of margin requirements should be part of final rules

Margin and Capital Requirements

Capital

- Prudential regulators propose relying on their existing capital rules and requirements to satisfy the DFA's mandate
- CFTC proposes that
 - If swap dealer/MSP is an FCM, it must comply with FCM net capital requirements with some enhancements
 - If swap dealer/MSP is non-bank subsidiary of U.S. bank holding company, must meet same requirements as BHC
 - Otherwise, swap dealer/MSP will be subject to minimum \$20 million tangible net equity requirement, plus additional amounts for market risk and OTC derivatives credit risk

Position Limits

Position Limits

- The DFA significantly expands and alters the position limit regimes implemented by the CFTC and the SEC.
- For the CFTC, the DFA amends Section 4a(a) of the Commodity Exchange Act (“CEA”) to:
 - expand the CFTC’s general authority to impose position limits, and
 - add several specific statutory mandates requiring the CFTC to impose position limits relating to physical commodities and swaps
- For the SEC, the DFA adds an entirely new section to the Securities Exchange Act—Section 10B—that authorizes the SEC to establish position limits.

Position Limits

- DFA imposed tight rulemaking deadlines on CFTC for position limits
 - Limits for physical commodity positions (other than agricultural commodities) to be established within 180 days of enactment (January 2011)
 - Limits for agricultural commodity positions to be established within 270 days of enactment (April 2011)
 - CFTC Commissioners had difficulty in agreeing on how to address this area
 - A major concern was that the CFTC simply did not have the data in hand to propose position limits with respect to the swaps market as contemplated by the DFA
 - Finally a rule proposal was released in January 2011, but Commissioner Sommers voted against the proposal and others expressed reservations, but wanted to solicit public comment
 - Since then, no apparent progress on this rule proposal
- However, the CFTC did earlier this month adopt as a new rule (also contemplated by the DFA) requiring enhanced reporting of physical commodity swaps by “Large Traders”

Position Limits

- New Rule (new Part 20 of CFTC's rules) does not establish any position limits. Instead it:
 - Calls for DCOs, clearing members and swap dealers to report swap positions and other data that will be relevant to any future effort to finalize the position limit rules contemplated by the DFA
 - Covers 46 physical commodities (energy, metals and ag)
 - Places a heavy focus on “economically equivalent swaps” which is one category that the DFA contemplates will ultimately be subject to rule making
 - Requires daily reporting, with the CFTC estimating the about 100 clearing members and 100 swap dealers will be required to report, along with about 5 DCOs
 - Becomes effective 60 days following publication in Federal Register, so likely to be effective sometime in September

Position Limits

- Key issues relating to position limits remain unresolved:
 - How will uncleared swaps be accounted for under the position limits (as the DFA mandates)
 - How will limits would apply to certain futures, options, and swaps (as the DFA contemplates)
 - Final scope of bona fide hedging exemption will be critical for ongoing dealer activities
- Economists have argued that position limits could have unintended negative effects and fail to address a legitimate problem—Limits might:
 - Impede price discovery by preventing traders from taking positions that optimize their information and their trading strategy
 - Decrease market efficiency
 - Not reduce market volatility and may impede convergence
 - Harm liquidity and increase hedging costs
 - Cause traders to migrate to markets without position limits
 - Could increase risks in the real economy

Recordkeeping - Reporting

Recordkeeping, Reporting, Confirmations and Documentation

- 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

Other

Other Considerations

- Coordinating between DFA and EMIR implementation
 - Difficulty within EU in getting agreement on EMIR means timetable is slipping but it is still hoped to be finalized by end 2011
 - It is however unlikely provisions will come into force until end 2012
- Coordination between CFTC and SEC
 - Commissioner O'Malia was critical of the CFTC's failure to harmonize its temporary exemptive relief with the SEC's and the failure to articulate an implementation plan to the market
- Impact of Lincoln and Volcker Provisions
- Impact of Basel III