

# DERIVATIVES REGULATION

## (as of July 16, 2011)

The Dodd-Frank Act requires various financial regulators—most notably, the CFTC and SEC—to establish the parameters of Title VII’s comprehensive new regulatory framework for swaps and security-based swaps through a vast number of rulemakings. During the past year, the CFTC and SEC held a series of roundtable discussions on core elements of Title VII and, given the enormous regulatory task at hand, encouraged public comment and industry participation throughout the rulemaking process. To date, that process has produced dozens of proposed rules but very few final rules. Critically important, and often controversial, aspects of Title VII, such as the key product and entity definitions, margin and capital requirements, end-user exception to clearing, clearinghouse ownership and membership requirements, and SEF structural requirements, have yet to be finalized.

Unless otherwise provided, Title VII provisions are effective on the later of July 16, 2011 or, to the extent that a provision requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing that 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 in July that, in effect, defer most Title VII requirements. The temporary exemptions do not, however, limit the agencies’ antifraud or antimanipulation authority, which will apply on July 16, 2011.

### Lincoln Provision (the “Swaps Pushout” Rule)

- No “Federal assistance” (*e.g.*, advances from any Federal Reserve credit facility or discount window that is not part of a broad-based eligibility program, FDIC insurance, or guarantees) may be provided to any “swaps entity” (*i.e.*, swap dealers and non-bank MSPs).
- The prohibition does not apply to insured depository institutions that limit their swap activities to (i) hedging and other similar risk mitigating activities directly related to their activities and (ii) engaging in swaps involving rates or reference assets that are permissible for investment by national banks. For purposes of the exception in clause (ii), credit default swaps are permissible only if cleared.
- The prohibition only applies to swaps entered into after the end of the transition period, which could be up to five years after enactment.

### Regulatory Framework and Key Definitions

- The Act creates parallel regulatory regimes for the CFTC and SEC and divides jurisdiction between the two regulators based on whether a “swap” or a “security-based swap” is involved. The CFTC will have jurisdiction over “swaps” and certain swap market participants, and the SEC will have jurisdiction over “security-based swaps” and certain security-based swap market participants. Banking regulators will retain jurisdiction over certain aspects of banks’ derivatives activities (*e.g.*, capital and margin requirements, prudential requirements).
  - **Swap.** This term is broadly defined to include many types of derivatives across various asset classes, but excludes, among other things, nonfinancial or security forwards that are intended to be physically settled, futures contracts, listed FX options, debt securities, securities options and forwards that are subject to the Securities Act of 1933 (“33 Act”) and the Securities Exchange Act of 1934 (“34 Act”), and security-based swaps. FX swaps and FX forwards qualify as swaps, unless the Secretary of the Treasury determines otherwise; however, notwithstanding any such determination, all FX swaps and FX forwards must be reported to a swap data repository or, in the absence of one, to the applicable regulator, and swap dealer and MSP counterparties to FX swaps and FX forwards must conform to business conduct standards applicable to swap dealers and MSPs. On April 29, 2011, the Secretary of the Treasury issued a proposed determination that exempted FX swaps and FX forwards from the swap definition, but noted that the exemption would not apply to FX options, currency swaps, and non-deliverable forwards.
  - **Security-based Swap.** A “security-based swap” is a swap on a single security or loan or a narrow-based security index (generally, an index with 9 or fewer component securities). The definition also includes credit default swaps relating to a single issuer or the issuers in a narrow-based security index.
- The Act creates two new categories of significant market participants: swap dealers and major swap participants.
  - **Swap Dealer.** A “swap dealer” is 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 engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. The term excludes persons that enter into swaps for their own account, either individually or in a

fiduciary capacity, but not as a part of a regular business. It also does not include insured depository institutions that offer to enter into swaps with their customers in connection with originating loans with those customers. The Act requires the CFTC and SEC to prescribe a *de minimis* exception to being designated as a swap dealer.

- **Major Swap Participant.** A “major swap participant” (“MSP”) is any person who is not a swap dealer and:
  - Maintains a “substantial position” (to be defined by the applicable regulators) in swaps for any major swap category, excluding positions held for hedging or mitigating commercial risk and positions maintained by any 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 US banking system or financial markets; or
  - Is a financial entity that is highly leveraged relative to the amount of capital that it holds, is not subject to any Federal banking agency’s capital requirements, and maintains a “substantial position” in outstanding swaps in any major swap category.
  - Certain captive finance affiliates of manufacturers that use swaps to hedge commercial risks relating to interest rate and FX exposures are excluded from the definition of major swap participant.

### **Clearing and Trading Requirements**

- **Mandatory Clearing.** A swap must be cleared if the applicable regulator determines that it is required to be cleared and a clearing organization accepts the swap for clearing.
  - The determination process may be initiated by the applicable regulator or by a clearing organization, and may relate to any single swap or any group, category, type, or class of swaps.
  - Mandatory clearing requirement will not apply to existing swaps if they are reported to a swap data repository or, if none, to the applicable regulator in a timely manner.
- **Commercial End User Exception.** The Act provides an exception to the mandatory clearing requirement if one of the counterparties to the swap (i) is not a financial entity, (ii) is using swaps to hedge or mitigate commercial risk, and (iii) notifies the applicable regulator how it generally meets its financial obligations associated with entering into non-cleared swaps. Application of the exception is at the sole discretion of the commercial end user.
  - The term “financial entity” includes swap dealers, MSPs, commodity pools, private funds (as defined in the Investment Advisers Act of 1940), employee benefit plans, and persons predominantly engaged in activities that are in the business of banking or in activities that are financial in nature, but excludes certain captive finance affiliates. The Act directs the applicable regulators to consider whether to exempt small banks, savings associations, farm credit system institutions, and credit unions.
- **Mandatory Trade Execution.** To the extent that a swap must be cleared, it must be executed on an exchange or swap execution facility, unless no exchange or swap execution facility makes the swap available for trading.
- **Non-ECPs.** Persons who are not eligible contract participants (“ECPs”) must always enter into swaps via an exchange.
  - For swaps, the illegality applies to the non-ECP.
  - For security-based swaps, the illegality applies to any person effecting the transaction with or for the non-ECP.

### **Regulation of Swap Dealers and Major Swap Participants**

- **Registration.** Swap dealers and MSPs must register as such and will be subject to a regulatory regime that will be defined, to a very large extent, by rulemaking. Registration is required with an applicable regulator regardless of whether the entity is registered with the other applicable regulator or is a depository institution.
- **Capital and Margin.** The applicable regulators (for non-banks) and the Federal banking regulators (for banks) will set minimum capital requirements and initial and variation margin requirements for swap dealers and MSPs.
  - To offset the “greater risk” of non-cleared swaps, the capital and margin requirements must help ensure the safety and soundness of the swap dealers and MSPs and be appropriate for the risk associated with the non-cleared swaps held by those entities.
  - The Act permits the use of noncash collateral and, for non-cleared swaps, requires swap dealers and MSPs to hold their counterparties’ initial margin, upon request, in a segregated account at an independent third party custodian.

- The Act does not provide an exemption to the margin requirements for commercial end users, although Senators Dodd and Lincoln stated in a June 30, 2010 letter to Chairmen Frank and Peterson their view that the Act does not authorize the regulators to impose margin requirements on commercial end users. In their proposed margin requirements, the CFTC would not impose margin requirements on non-financial entities. In contrast, the banking regulators have proposed applying a margin requirement to nonfinancial end-users, but any such requirement would be reduced to the extent that the swap dealer or MSP counterparty has established any applicable credit exposure limit for the nonfinancial end-user.
- **Business Conduct Standards.** Swap dealers and MSPs must conform with business conduct standards, including:
  - Disclosure to non-swap dealer and non-MSP counterparties of the material risks and characteristics of the swaps and any material incentives or conflicts of interest that the swap dealer or MSP may have in connection with the swaps; and
  - Additional responsibilities with respect to “special entities” (*i.e.*, States, municipalities, State and Federal agencies, pension plans, governmental plans, and endowments):
    - ♦ A swap dealer that acts as an advisor to a special entity has a duty to act “in the best interests of” the special entity; and
    - ♦ A swap dealer or an MSP that offers or enters into a swap with a special entity must comply “with any duty” established by the applicable regulator that requires the swap dealer or MSP “to have a reasonable basis to believe” that the special entity is advised by a qualified independent representative.

### **Miscellaneous**

- The Act increases eligibility requirements for individual and governmental entity ECPs
- The applicable regulators are authorized to establish aggregate position limits and large trader reporting requirements for swaps.
- Swaps shall not be considered to be insurance and may not be regulated as insurance contracts under State law.
- Offers and sales of security-based swaps to non-ECPs must be registered, notwithstanding sections 3 and 4 of the 33 Act.
- The beneficial ownership rules in sections 13 and 16 of the 34 Act apply to persons who purchase or sell security-based swaps on or after July 16, 2011.