ALERTS AND UPDATES

U.S. Financial Reform: The Regulation of Derivatives and Swap-Trading Provisions

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Act") begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts *on many of the broad topics addressed by the Act, accessible at* www.duanemorris.com/FinancialReform.

Title VII of the Act, designated the "Wall Street Transparency and Accountability Act of 2010," will significantly change how derivatives and the market participants that use them will be regulated. Historically, the over-the-counter swaps market has functioned without regulation, with trading taking the form of customized bilateral contracts. Each contract is non-uniform, with varying terms and varying margin requirements. As a result, counterparties throughout the financial system were interconnected with little transparency and a notional amount that often was not indicative of actual economic exposure. The U.S. Congress, in passing Title VII, has instituted a new framework to manage "systemic risk"[1] within the financial system. Title VII will require more derivative transactions to be executed on regulated exchanges and electronic trading platforms, and to be centrally cleared through regulated clearinghouses. Many key details of Title VII will be defined and interpreted through the regulatory rulemaking process and are not set forth in the Act itself. Title VII will, among other things:

- Require banks to push out certain swap-dealing activities that do not constitute "bona fide hedging and traditional bank activities";
- Establish a comprehensive framework for the registration and regulation of dealer and "major" nondealer market participants regarding their "swap" activity;
- Exempt companies that use swaps to hedge "commercial risk"[2] (end users) from the clearing and exchange-trading requirements, but not from margin requirements;
- Require derivatives that are capable of being cleared, to be cleared and traded on an exchange; and
- Require regulators to set minimum capital requirements and minimum initial and variation margin requirements.

Title VII gives the U.S. Commodity Futures Trading Commission (CFTC) and the U.S. Securities and Exchange Commission (SEC) (collectively, the "Commissions") one year to enact most of the required rulemaking and regulations. Title VII categorizes the derivatives transactions within its scope as either "swaps," which are subject to primary regulation by the CFTC; "security-based swaps," which are subject to primary regulation by the SEC; or "mixed swaps," which are subject to joint regulation by the CFTC and SEC. Because many of the requirements of Title VII are nearly identical for both swaps and security-based swaps, for ease of presentation, unless otherwise indicated, the term "swaps" is used in this *Alert* to refer to both "swaps" and "security-based swaps."

Pushing Out Swaps Activity

Title VII requires banks to push out "riskier" trades – defined as those that a bank is not permitted to hold under the National Bank Act, including non-cleared credit default swaps (CDS), CDS against asset-backed securities, commodity and agriculture swaps, equities, energy swaps, and metal swaps excluding gold and silver – into a separately capitalized affiliate.

Failure to make the push-out will cause the bank to lose federal assistance, including FDIC insurance and access to the Federal Reserve's discount windows.

Title VII allows banks to engage in certain swaps (defined as "bona fide hedging and traditional bank activities") including interest rate swaps, foreign exchange swaps and forwards, credit swaps, gold and silver, investment grade CDS and other transactions used to hedge the bank's own risk.

The provisions of Title VII are designed to curb systemic risk by reducing the ability of the insured banks to engage in proprietary trading, including swaps, and also to prohibit the federal government from bailing out a "swaps entity" (as defined below). For further information on the Act's prohibitions on insured banks' proprietary trading, please see our *Alert* "The Volcker Rule and Improvements in the Regulation of Banking Entities and Nonbank Financial Companies Supervised by the Board of Governors of the Federal Reserve System."

The push-out provision will take effect on July 21, 2012; and all existing swaps contracts in effect as of that date, including those entered into during the transition period, will be grandfathered. The transition period will be set by the applicable bank regulator and, as such, there is no set transition period applicable to all contracts.

Who Is Affected?

In addition to the push-out provision, the Act also mandates regulation of market participants and establishes new categories of regulated entities, including "swaps entities." A "swaps entity" is any "swaps dealer" or "major swap participant" (MSP) that is required to be registered by Title VII.

A "swaps dealer" is an entity whose business is based on entering into swaps, who represents itself as a dealer of swaps, who creates a market in swaps or who engages in activities that create a trade reputation of being a dealer. Title VII provides that the relevant Commission must provide an exemption from registration for dealers that engage in a "de minimis quantity of swap dealing," which will be defined through Commission rulemaking, in connection with transactions with or on behalf of customers. The definition of "swaps dealer" remains subject to further clarification by the Commissions' regulations.

An MSP is a non-swaps dealer entity that maintains a "substantial position" – which will be defined through Commission rulemaking – in swaps (excluding positions held for "hedging or mitigating commercial risk" and positions held by employee benefit plans for hedging purposes) that could have "serious adverse effects" on U.S. market stability; or that is highly leveraged, is not subject to bank regulators' capital requirements and maintains a substantial position in swaps. Title VII mandates that the SEC and CFTC clarify the scope and reach of the definition of an MSP through regulation.

The definition of an MSP is likely to be significant because it may include hedge funds, and if it does, it would subject hedge funds to capital requirements that are mandated by Title VII to take into account "the risks associated with other types of swaps . . . engaged in and the other activities conducted by [the hedge fund or other nonbank MSPs] that are not otherwise subject to regulation." In other words, in such circumstances, capital requirements may be based on the entity's entire operations.

Clearing and Exchange Trading

The cornerstone of Title VII is the centralized clearing requirement. Centralized clearing is mandated for all swaps that the CFTC or the SEC determines should be cleared through a registered clearinghouse, and that are otherwise accepted by one or more clearinghouses for clearing. Transactions that are subject to mandatory clearing are also required to be traded on a designated contract market or "swap execution facility" (for "swaps") or a national securities exchange or "security-based swap execution facility" (SEF) – meaning a facility that accepts bids and offers made by multiple participants (for "security-based swaps") – unless no such venue accepts the transaction. If neither an exchange nor an SEF is willing to list the swap, counterparties to the contract would nevertheless be required to comply with any relevant CFTC or SEC recordkeeping and reporting requirements, as well as applicable capital and margin requirements.

Highly customized swaps that are not suitable for clearing may still be executed; however, such swaps must be reported to a trade repository or to the applicable Commission. Moreover, swap dealers and major swap participants (MSPs), discussed below, entering into non-cleared swaps may face potentially significant margin requirements.

End-User Exemption

End users are exempt from the centralized clearing requirement if they:

1. Are not financial entities,
2. Are using the swap to hedge commercial risk, and
3. Notify the relevant Commission on how they generally meet their financial obligations related to entering non-cleared swaps in a manner to be determined by the Commission.

The term "financial entity" includes swaps 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, excluding certain captive finance affiliates. Title VII requires the Commissions to consider whether to exempt small banks, savings associations, farm credit system institutions, and credit unions.

Margin and Capital Requirements

Title VII requires that regulators of financial institutions must, upon consultation with the Commissions, set minimum capital and initial and variation margin requirements for banking institutions. The Commissions will set the requirements for nonbank institutions, which are to address systemic risk resulting from a high volume of derivatives activity, securities borrowing and lending, repossessions, and activity that, if stopped, would create a substantial disruption in financial markets. Title VII requires that such requirements must permit the use of noncash collateral to satisfy margin requirements. The Commissions are given broad discretion in determining the appropriate regulations regarding margin requirements.

Title VII currently does not provide an exemption from the margin requirements for an end user who is a counterparty to a swap. Additionally, Title VII contains no provision exempting swaps entered into pre-enactment from the margin requirements for uncleared swaps under the Act.

Business-Conduct Requirements

Title VII requires registered swaps dealers and MSPs to conform to any business-conduct standards set by the Commissions pertaining to fraud, supervision, adherence to position limits and any other matter that the Commissions determine to be appropriate. Additionally, Title VII imposes stiffer conduct requirements on swaps dealers and MSPs that deal with "special entities" – *i.e.*, pension funds; endowments; retirement plans; and federal, state and local government agencies and entities – including an obligation to make detailed disclosure to the special entity of the swaps dealer's capacity for each transaction. The extent of the business-conduct requirements may depend in large part on the Commissions' interpretation of the aforementioned business-conduct standards and their enactment of such rules and regulations.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes videos and the firm's comprehensive series of *Alerts* analyzing the provisions of the Act and emerging policies, as well as links to relevant government websites. Duane Morris' attorneys will be monitoring the rules and regulations released under the Act, as well as the regulatory agencies' interpretive guidance. For subsequent *Alerts* on these and other topics, please revisit www.duanemorris.com and www.duanemorris.com/FinancialReform.

For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact Joel N. Ephross, Miriam O. Hyman, F. Reid Avett, any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.

As required by United States Treasury Regulations, you should be aware that this communication is not intended by the sender to be used, and it cannot be used, for the purpose of avoiding penalties under United States federal tax laws.

Notes

1. "Systemic risk" is not defined in the Act, but is commonly defined as the risk inherent to the entire market or entire market segment.
2. Financial risk assumed by a party extending credit without collateral or a means of recourse.