

## Uncharted Territory: Landmark Financial Reform Legislation Fundamentally Redefines Derivatives Markets

July 1, 2010

The U.S. House of Representatives recently passed legislation that changes the nation's financial regulatory system. Important details regarding how markets and firms will be regulated if it is enacted will be decided through a rulemaking "ultra-marathon."

On June 30, 2010, the U.S. House of Representatives passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, effectively ending months of public debate and intense lobbying over how to reform the U.S. financial regulatory system. An identical version of the 2,319-page bill now goes to the U.S. Senate, which is expected to consider the proposal after the Fourth of July recess.

The bill contains 16 separate titles that touch upon nearly every aspect of the U.S. financial system. By dramatically expanding the regulation of banks, consumer lending, insurance, hedge funds and the bilateral and multilateral trading of derivatives, the bill changes the landscape for institutions and markets. Title VII of the bill, the Wall Street Transparency and Accountability (WSTA) Act of 2010, addresses derivatives markets and closely tracks the legislation first proposed in the U.S. Senate Agriculture Committee in April 2010. In many respects, it is more far-reaching than the original proposals from the Obama administration and the U.S. House of Representatives. The WSTA Act includes significant new registration and other requirements on certain market participants, namely, swap dealers and major swap participants, and requires the clearing and exchange trading of many currently exempt, over-the-counter derivative products.

### Rulemaking "Ultra-Marathon"

While it is clear that, if enacted, this law will significantly impact the financial sector, many important details remain unclear, particularly with respect to the trading of energy, agricultural and related derivatives products. The details will be addressed through a statutorily imposed rulemaking "ultra-marathon" during which the U.S. Commodity Futures Trading Commission (CFTC) will be required to draft up to 50 new rules over 360 days. These rulemakings will affect nearly every aspect of the Commodity Exchange Act, including what swaps are required to be cleared, what capital and margin requirements apply to swap dealers and major swap participants, and the contours of the exemption for commercial end-users. The CFTC also will address its newly-defined anti-manipulation standard.

The CFTC and/or U.S. Securities Exchange Commission (SEC) also are required to:

- Establish new position limits for futures contracts and certain swaps
- Determine whether to exempt small banks, savings associations, farm credit system institutions, and credit unions from the definition of "financial entity" in connection with the mandatory clearing requirement
- Prescribe rules to prevent evasions of the mandatory clearing requirement
- Adopt rules to impose capital and margin requirements on entities that trade in swaps
- Define "commercial risk" and "substantial position"
- Further define what the terms "swap," "swap dealer," "major swap participant" and "eligible contract participant" mean in order to include any transactions and entities that have been structured to evade the new law

In the meantime, many critical questions remain unanswered. Among them:

- How broadly will the CFTC construe the definition of “swap dealer,” which currently captures any person who “regularly enters into swaps with counterparties as an ordinary course of business for its own account”?
- What will be the extent of the financial obligations the CFTC seeks to impose for non-cleared swaps executed pursuant to the exemption for end-users?
- To what extent will the CFTC seek to set capital requirements for swap dealers and major swap participants based on risks associated with swaps that are not otherwise subject to regulation?

### **Spin-Off and Push Out: Derivatives Firms Face New Organizational Limitations**

Among other things, the new law restricts large financial institutions dealing in certain derivatives from receiving financial assistance from the Federal Deposit Insurance Corporation or the Federal Reserve. Financial institutions that want to retain their eligibility for such programs will need to spin off or push out their swap-dealing entities into separate affiliates that will have to comply with a host of regulations to be developed jointly by the CFTC, the SEC and the Federal Reserve. Financial institutions that engage solely in bona fide hedging involving interest rate, currency and bullion swaps are not subject to the push out provision.

The new law also restricts the ability of any “banking entity” to engage in proprietary trading. The prohibition of proprietary trading is, however, subject to certain exceptions for “permitted activities,” including certain activities that occur wholly outside the United States and activities deemed to be “de minimis.”

### **Out With the Old, In With the New**

The stated goal of the WSTA Act is to promote greater transparency and stability in the derivatives markets. To that end, the law radically amends the Commodity Exchange Act in several significant ways:

- Exemptions and exclusions repealed—The law eliminates the statutory exclusions and exemptions previously available for certain bilateral swap transactions pursuant to the Commodity Futures Modernization Act of 2000.
- Swap dealers and major swap participants—The law creates new categories of market participants. Swap dealers and major swap participants will be required to register with the National Futures Association and will have to comply with significant new regulatory requirements, including mandatory clearing, exchange trading, reporting, business conduct standards and segregation requirements. Swap dealers and major swap participants also will be subject to capital and margin requirements that could affect their credit ratings. In contrast, market participants who are end-users or other non-financial entities will have more flexibility under the new framework, particularly with respect to swaps used to hedge or mitigate commercial risk.
- Mandatory clearing and exchange trading—The law mandates that most swaps be cleared and traded on a registered exchange. End-users may elect not to clear their swaps although their uncleared swaps may still be subject to margin requirements. The clearing exception is limited to non-financial entities. Swaps that are not offered for clearing or traded on an exchange still will have to be reported to a “swap data repository” or the CFTC.
- Swap execution facilities—The law creates two new categories of registered facilities, swap execution facilities (for trading cleared swaps) and swap data repositories (for reporting both cleared and uncleared swaps).

The U.S. Senate is expected to vote during the week of July 12 on the version of the WSTA Act that was passed by the House June 30. If the WSTA Act is approved by the Senate, President Obama is expected to quickly sign the bill into law. Most provisions in the WSTA Act will not become effective until the later of 360 days after enactment or 60 days after the applicable regulations are promulgated. However, work on the numerous rulemakings required to implement the legislation will begin almost immediately.