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The Dodd-Frank Act

Commentary and **Insights**

Excerpts

Skadden

Swap Clearinghouses and Markets

An objective of Title VII of the Dodd-Frank Act is to create a structure and incentives to expand pre- and post-execution transparency for swaps and security-based swaps¹ and contain the consequences of the failure of a party with a massive swaps position. The Act mandates regulated, centralized clearing and trading environments for swap agreements or, where clearing is unavailable, imposes effective collateralization and capital requirements to protect counterparties and to discourage over-leveraging.

What Must Be Cleared?

All swaps not subject to enumerated exceptions must be submitted for clearing to a registered derivatives clearing organization or a derivatives clearing organization exempt from registration under the Act.² The enumerated exceptions to the clearing requirement are limited. A swap is exempt from the clearing requirement if one of the counterparties is not a financial entity and is using the swap to hedge or mitigate its commercial risk, and that party notifies the CFTC how it generally meets the financial obligations associated with entering into a non-cleared swap. The CFTC is to set forth the manner of notification that will be required.³

“Financial Entity” is broadly defined in this context and includes a swap dealer, major swap participant, private fund as defined by section 202(a) of the Advisers Act, an employee benefit plan under section 3 of ERISA, and a person predominantly engaged in banking or financial activities.⁴ Some leeway in this definition remains, however, because the CFTC is given discretion to determine whether small banks, savings associations, farm credit system institutions and credit unions are exempt. Additionally, the definition of “financial entity” does not include any entity the primary business of which is providing financing and which uses derivatives to hedge commercial risks related to interest-rate and foreign currency exposure, if 90% or more of the exposures arise from financing that facilitates the purchase or lease of products, 90% or more of which is manufactured by the parent company or another subsidiary.⁵

An affiliate of a person that qualifies for the exemption may avail itself of the exemption if it is acting as an agent of the person or another affiliate so long as it is not a swap dealer, a major swap participant, an issuer that would be defined as an investment company, a commodity pool, or a bank holding company with over \$50 billion in consolidated assets. Additionally, the Act provides a transition period for the benefit of affiliates that are predominantly engaged in providing financing for the purchase or lease of merchandise or manufactured goods. Such affiliates are exempt from the clearing requirements as well as the margin requirements of the Act with regard to swaps entered to mitigate the risk of financing activities for at least two years.⁶

Notably, these exceptions may be narrowed, at least to some extent, by the CFTC. That is, the CFTC may prescribe and interpret rules it determines to be necessary to “prevent abuse of the exceptions.”⁷

¹ For the definitions of “swap” and “security-based swap,” see [“Regulation of Over-the-Counter Derivatives Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.”](#)

² Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(1)).

³ Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(A)).

⁴ Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(C)).

⁵ *Id.*

⁶ Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(D)).

⁷ Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(F)).

No further guidance as to what constitutes an “abuse” is given, leaving the CFTC with considerable discretion. Additionally, obvious efforts to structure swaps to avoid clearing may be precluded. The SEC and CFTC are specifically granted the power to prescribe rules determined to be necessary to “prevent evasion” of the mandatory clearing requirement.⁸ No further guidance as to the exercise of this power is given by the Act; however, the CFTC is specifically tasked with adopting rules to further define “swap,” “swap dealer,” “major swap participant,” and “eligible contract participant” in order to include transactions or entities that have been structured to evade these provisions.⁹ Additionally, a designated clearing organization, swap dealer, or major swap participant that knowingly or recklessly evades or participates in or facilitates an evasion of the clearing requirement is liable for a money penalty in twice the amount otherwise available for such a violation.¹⁰

Also, if the CFTC finds that a particular swap that otherwise would be subject to the mandatory clearing requirement is not listed by a derivatives clearing organization, it may investigate such a situation, issue a public report within 30 days, and take whatever actions it determines to be necessary and in the public interest, including requiring the retention of adequate margin or capital by parties to the swap (but not including requiring a reluctant clearinghouse to clear the contract). More specifically, the CFTC is not authorized to require a derivatives clearing organization to list a swap for clearing if such an action would threaten its financial integrity.¹¹ This protection, however, appears to be minimal and may only allow derivatives clearing organizations to refuse required clearing in the most dire circumstances and, in any case, will require a derivatives clearing organization to perform a defensive analysis in order to fend off an unwanted swap.

Regardless, the Act provides some incentive to dealers to structure swaps as clearable. Most notably, the Act provides a roadblock for publicly traded corporations to participate in uncleared swaps. If a publicly traded corporation wishes to avail itself of an exemption from the clearing requirement or even wishes not to trade a cleared swap on a board of trade, designated contract market, or swap execution facility, it must first receive approval from the appropriate committee of its board or governing body.¹² This could result in large delays before such an entity could enter into a swap, or at least would require the entity to plan ahead to receive timely audit committee approval. However, although it is not entirely clear, the language of the Act (“only if an appropriate committee of the issuer’s board or governing body has reviewed and approved its decision to enter into swaps that are subject to such exemptions”)¹³ may permit the appropriate body to issue an effective blanket approval to enter into uncleared swaps, or at least certain large categories of uncleared swaps.

Swaps not subject to the clearing requirement are still subject to additional regulation imposed by the Act. All swaps, cleared or uncleared, must be reported to a swap data repository, a registered entity that collects and maintains records with respect to transactions or positions in, or terms and conditions of, swaps.¹⁴ Additionally, in what appears to be a somewhat overlapping provision, the Act provides that swaps that are not accepted for clearing by any derivatives clearing organization must be reported

⁸ *Id.*

⁹ Act § 721(c).

¹⁰ Act § 741(a).

¹¹ Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(4)(C)).

¹² Act § 723(b) (to be codified at 7 U.S.C. 2(j)).

¹³ *Id.*

¹⁴ Act § 727 (to be codified at 7 U.S.C. 2(a)(13)(G)).

to a swap data repository, or if no repository will accept the swap, to the CFTC itself.¹⁵ These reporting requirements are to some extent retroactive, because the Act provides that swaps entered into before the enactment of the clearing subsection must be reported to a swap data repository or the CFTC within 180 days of the effective date of the subsection.¹⁶ Additionally, in what again may be an overlapping provision, the Act provides that pre-enactment swaps, the terms of which have not expired as of enactment, must be reported to a registered swap data repository or the CFTC within 30 days of the issuance of a final rule by the CFTC regarding reporting of pre-enactment swaps or within any other time period determined by the CFTC.¹⁷ All foreign exchange swaps must be reported regardless of whether the Treasury Secretary determines that they should not be regulated as swaps.¹⁸ Additionally, if an individual or entity fails to clear a swap or report the swap to a swap data repository in accordance with the rules, it must maintain records regarding the swaps it holds in a manner prescribed by the CFTC and provide reports upon request of the CFTC.¹⁹

The Act provides guidance as to which party to a swap, under certain circumstances, has the right to choose where the swap will be cleared: the party to a swap other than a swap dealer or major swap participant may select the clearinghouse. Specifically, in a swap subject to the clearing requirement entered into by a swap dealer or major swap participant with a counterparty that is not a swap dealer or major swap participant, the counterparty that is not a swap dealer or major swap participant has the right to select a derivatives clearing organization at which to clear a swap.²⁰ In the case of a swap that is not subject to the clearing requirement entered into by a swap dealer or major swap participant and a counterparty that is not a swap dealer or major swap participant, the counterparty may first elect to require the swap to be cleared and, if it makes such an election, has the right to select the derivatives clearing organization at which the swap will be cleared.²¹ The Act does not explicitly prohibit dealers from refusing to deal unless their choices of clearing agency are respected.

Although many provisions of the Act appear to be retroactive, the clearing requirement is not. **See “Derivatives.”** According to the terms of the Act, any swap that was entered into prior to enactment is not subject to the mandatory clearing requirement, although such swaps must be reported to a swap data repository within 180 days after the effective date of the clearing requirement. Similarly, swaps entered into after enactment but before application of the clearing requirement are not required to be cleared, but must be reported to a swap data repository either 90 days after the effective date or such other time as specified by the CFTC.²² In addition, persons may petition to avoid the mandatory clearing requirement for a year after enactment of the Act. Specifically, no later than 60 days after enactment, a person may submit a petition to the CFTC requesting to remain subject to Section 2(h) of the Commodity Exchange Act, thereby avoiding the new mandatory clearing provisions for up to a year.²³ No guidance is given regarding how the CFTC will decide to deny or approve such petitions, but the CFTC is required to consider petitions in a “prompt” manner.²⁴

¹⁵Act § 729.

¹⁶Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(5)).

¹⁷Act § 729.

¹⁸Act § 721(a)(21) (to be codified at 7 U.S.C. 1a(47)(E)(iii)).

¹⁹Act § 729.

²⁰Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(E)(i)).

²¹Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(E)(ii)).

²²Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(6)).

²³Act § 723(c).

²⁴Act § 723(c)(2)(A).

Role of the Regulator in Determinations Related to Clearing

According to the Act, the CFTC occupies a gate-keeping role in determining which swaps must be cleared. The CFTC may review swaps by two alternative means. First, and perhaps of greatest concern, it may review a swap or group, category, type or class of swaps to determine whether it should be required to be cleared on its own initiative.²⁵ The CFTC must consider several broad factors in making its decision:

- the existence of significant outstanding notional exposures, trading liquidity and adequate pricing data;
- the availability of rule framework, capacity, operational expertise and resources and credit infrastructure to clear the contract;
- the effect on mitigation of systematic risk; and
- the effect on competition; and the existence of reasonable legal certainty in the event of the insolvency of the derivatives clearing organization or its members.

Regardless of these factors, it remains difficult to predict what swaps will be subject to the requirement.²⁶

Alternatively, a derivatives clearing organization is required to submit any group, category, type or class of swaps that it plans to accept for clearing to the CFTC.²⁷ Any swap, group, category, type or class of swaps listed for clearing as of the enactment of Section 723 is, however, deemed already submitted. Thereafter, the CFTC has 90 days, unless the submitting entity agrees to an extension, to make a determination as to whether the clearing requirement should apply. In making its determination, the CFTC is to consider whether clearing the swap at issue is consistent with the core principles for derivatives clearing organizations prescribed by the Act as well as the considerations described above.²⁸

After making its initial determination on a swap submitted by a derivatives clearing organization, the CFTC on its own initiative or at the request of a counterparty may stay the clearing requirement until it completes a review of the terms of the swap and the clearing arrangement. Unless the derivatives clearing organization that clears the swap agrees to an extension, the CFTC must determine within 90 days after issuing the stay whether the swap must be cleared.²⁹

As a corollary, if a swap is subject to the clearing requirement, it also is required to be executed on a regulated platform. That is, it must be traded on a designated contract market or a registered swap execution facility.³⁰ The only exception to this requirement is if no designated contract market or swap execution facility makes the swap available for trade.³¹ Additionally, the Act makes it unlawful for any person other than an eligible contract participant to enter into a swap that is not on or subject to the rules of a board of trade or designated contract market.³²

²⁵Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(2)(A)).

²⁶Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(2)(A)).

²⁷Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(2)(B)).

²⁸Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(2)(D)).

²⁹Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(3)(A-C)).

³⁰Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(8)(A)).

³¹Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(8)(B)).

³²Act § 723(a)(2) (to be codified at 7 U.S.C. 2(e)).

Swap Execution Facility

The Act creates a new regulated trading platform called a swap execution facility. A swap execution facility is defined as “a facility trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that facilitates the execution of security-based swaps between persons and is not a designated contract market.”³³ This definition is broad and encompasses a large number of previously unregulated entities. Uncertainty remains as to exactly what can be traded on a swap execution facility, and the Act allows the CFTC and SEC to promulgate rules defining the universe of swaps that may be traded on a swap execution facility.³⁴

The deletion of one word from the Act has created significant uncertainty regarding the conduct of trading on a swap execution facility. The Act had originally required that a swap execution facility be a “trading facility.” The word “trading” was omitted from the final version of the Act. Eliminating “trading” and requiring only that a swap execution facility be a “facility” could have important consequences. The Commodity Exchange Act definition provides that a “trading facility” does *not* include:

a person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, nondiscretionary automated trade matching and execution algorithm.³⁵

This language, defining what isn't a “trading facility” has been interpreted to mean that any “trading facility” must have an automated matching and execution algorithm. Therefore, striking the word “trading” from “trading facility” frees the operator of the facility from the automated matching requirement. The swap execution facility remains subject to the requirement that it be: “a facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system” Critics of this amendment have suggested that it permits swap dealers to operate private trading systems, but the use of the plural “participants” may preclude that reading. The question is whether the language requires that there be at least two market makers and two potential customers for each trade.

Regulation of Clearinghouses

As a corollary to the clearing requirement, the Act requires open access to derivatives clearing organizations. The open access provision requires that a derivative clearing organization's rules prescribe non-discriminatory clearing. The goal of the drafters was to preclude the tight vertical relationship between exchanges and their clearinghouses, which is a common feature of futures markets. The Act requires a clearinghouse to accept transactions without regard to the platform on which they were executed.³⁶ It is likely however, that the contracts must be equivalent to contracts already being cleared by that clearinghouse. Effectively, if contracts traded on separate platforms are identical, they become fungible if cleared at the same clearinghouse.

³³Act § 721(a)(21) (to be codified at 7 U.S.C. 1a(50)).

³⁴Act § 733.

³⁵7 U.S.C. 1a(34).

³⁶Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(1)(B)).

The Act prescribes a shared scheme of regulation; the CFTC and the SEC share the power to regulate derivatives clearing organizations, designated contract markets, and swap execution facilities based on the type of swap at issue. Pursuant to the Act, the CFTC and the SEC both issue rules and regulations related to the Act, but they must consult and coordinate with each other to assure that the regulations prescribed by each are consistent. Importantly, however, although the CFTC and SEC must treat functionally or economically similar products and entities in a similar manner, they need not treat them in an identical manner.³⁷

The CFTC has been given authority to regulate swaps and the SEC has been given authority to regulate securities-based swaps. Specifically, the CFTC may not issue a rule or regulation related to securities-based swaps or related to dealers, major participants, repositories, associated persons of dealers or major participants, eligible contract participants, or swap execution facilities with respect to securities-based swaps, and the SEC may not regulate the same as to swaps.³⁸ In a similar vein, absent certain issues reserved for prudential regulators, the CFTC has sole enforcement authority as to the portions of the Act dealing with swaps and related entities, and the SEC has “primary” enforcement authority regarding the portions of the Act dealing with securities-based swaps and related entities.³⁹ The CFTC and SEC, after consultation with the Board of Governors, are to jointly prescribe regulations regarding mixed swaps.⁴⁰

The CFTC and SEC, in consultation with the Board of Governors, are also to jointly further define various terms relevant to the Act including “swap,” “swap dealer,” “major swap participant” and “eligible contract participant” as well as other rules regarding such definitions as they determine are necessary and appropriate in the public interest and for the protection of investors.⁴¹ Additionally, they are to jointly prescribe various rules governing recordkeeping related to swaps.⁴² If the CFTC and SEC fail to jointly prescribe such rules in a timely manner, the Financial Stability Oversight Council may step in to resolve disputes at the request of either party.⁴³ Additionally, where joint regulations are required, any interpretation of provisions of the Act issued by a CFTC are effective only if issued jointly after consultation with the Board of Governors.⁴⁴ This portion of the Act clearly contemplates a slow and contentious rulemaking process.

The rules applying to swaps entities and security-based swaps entities provided in the Act — that is, clearing rules, core principles, and related provisions — are virtually identical. However, as discussed above, based upon the type of swap at issue, an entity or swap is subject to the rules promulgated pursuant to the Act by either the CFTC or the SEC or both. As such, an entity that deals in both swaps and securities-based swaps will face regulation by both the CFTC and the SEC, and the regulations prescribed by those commissions may differ, despite the fact that the entities at issue may be serving the same purpose regarding swaps and securities-based swaps.

³⁷Act § 712(a). See “Derivatives.”

³⁸Act § 712(b).

³⁹Act § 741.

⁴⁰Act § 712(a)(8).

⁴¹Act § 712(d)(1).

⁴²Act § 712(d)(2).

⁴³Act § 712(d)(3).

⁴⁴Act § 712(d)(4).

Regulation of Over-the-Counter Derivatives Under the Dodd-Frank Wall Street Reform and Consumer Protection Act

This article discusses certain key aspects of the new regulatory regime imposed by the Dodd-Frank Act on over-the-counter (“OTC”) derivatives and the market for such derivatives, which until now has developed largely free of regulation. The derivatives legislation is set forth in Title VII of the Act (entitled “Wall Street Transparency and Accountability” and referred to herein as the “Derivatives Title”). However, provisions under other titles of the Act, such as Title VI on banking organizations, also have the potential to significantly affect the OTC derivatives market. In particular, the so-called “Volcker Rule” will ban the proprietary trading of derivatives by bank holding companies and their affiliates and, therefore, could materially affect the derivatives activities of banking organizations that are subject to regulation by U.S. governmental authorities. **See “The Volcker Rule.”** Other provisions of Title VI, such as the inclusion of derivatives exposures under bank lending limits, also could affect the conduct of derivatives business by banking organizations.

With limited exceptions, the provisions of the Derivatives Title become effective on the later of 360 days following enactment and, to the extent a provision requires rulemaking, not less than 60 days after publication of the final rule (referred to herein as the “General Effective Date”). Many key concepts, processes and issues under the Derivatives Title have been left to the relevant regulators, primarily the CFTC and the SEC, to define and address. The rulemaking generally is required to be completed within 360 days following enactment. Accordingly, it is likely to be a number of months before clarity begins to emerge on some key points, including which market participants will be subject to registration and comprehensive regulation as major market participants (as discussed below).

Regardless of the many issues left to the regulators, it is clear that the derivatives legislation will change the operation of the derivatives markets and the regulation of market participants in many significant respects. The primary goals of the legislation and related rulemaking are to increase the transparency and efficiency of the OTC derivatives market and to reduce the potential for counterparty and systemic risk. The main mechanisms for achieving these goals are:

- to require that as many product types as possible be centrally cleared and traded on exchanges or comparable trading facilities;
- to subject swap dealers and major market participants to capital requirements and to margin requirements (to be imposed by clearinghouses for cleared swaps and by regulation for uncleared swaps); and
- to require the public reporting of transaction and pricing data on both cleared and uncleared swaps.

In addition, the Act imposes an array of new prudential regulations and compliance requirements for banks, swap dealers and other regulated (or newly regulated) entities, as well as more sweeping changes to some businesses, particularly banking organizations and companies that become subject to regulation as “significant nonbank financial companies.” **See “Regulation of Banking Organizations,” and “Key Measures to Address Systemic Risk.”**

In the short run, the major changes made by the Act to existing OTC derivatives market practices and to the conduct of business generally by banking organizations, financial entities and other market participants — in combination with transition periods that may be overly aggressive, in view of the necessary adjustments to business operations and practices and the volume of complex issues left to post-enactment rulemaking — could produce market dislocations and other unintended or unforeseen consequences. In addition, while the cost of swaps that become commoditized products generally may decrease due to improved market efficiencies (once the transitional issues have been resolved), the “bespoke,” uncleared transactions that some market participants will require appear likely to become more expensive because they probably will be subject to higher capital charges for their providers and fewer counterparties may be willing or able to provide them. The only swap counterparties likely to be at least partially shielded from higher costs on uncleared swaps are those who meet the requirements, described below, for “end users.” However, the end-user exemption will be unavailable to many types of entities.

The U.S. banks that conduct certain derivatives activities will become subject to a restriction on access to “federal assistance,” a restriction that effectively will require them to cease those activities following a transition period. If a banking organization wishes to continue to conduct the derivatives activities in question, it will be required to create and separately capitalize a nonbank affiliate to do so. The derivatives activities in which those entities will be able to engage will be further constrained by application of the Volcker Rule. See “[The Volcker Rule](#).” Some commentators question whether these requirements will achieve anything other than reducing the profitability of these organizations and suggest that the increased capital and other prudential regulatory requirements contained in the Act may in themselves have been sufficient risk mitigants.

Certain other market participants will become subject to the new registration, capital, margin, reporting and other compliance requirements applicable to Major Participants (as defined below). Particularly for Major Participants that are not currently regulated entities, these requirements seem likely to significantly increase the cost of doing business.

While many market participants could be affected by increased costs and increased regulatory oversight and reporting, the impact on some thinly capitalized, highly leveraged investment funds and structured finance vehicles could be significant and could make certain structures unfeasible. That may be fully intended as a legislative goal, given the widespread perception that the use of certain types of structured finance vehicles or transactions — particularly those based on credit derivatives — may have fueled the recent financial crisis.

Issues that have raised particular concern in recent weeks are (i) whether so-called end users (which, as discussed further below, are generally nonfinancial entities using swaps to hedge commercial risk), who will have the option to enter into uncleared swaps, will be exempt from the margin requirements to be imposed upon uncleared swaps, and (ii) whether margin requirements may be imposed generally on existing swap transactions on a retroactive basis. Although end-user swaps had been understood to be exempt from the margin requirements on uncleared swaps, based on wording in the Senate version of the derivatives legislation, that language was not included in the Act. Moreover, the Act contains no provision exempting swaps entered into pre-enactment from the margin requirements for uncleared swaps under the Act.

On June 30, Senators Dodd and Lincoln released a letter addressed to their counterparts on the Financial Services and Agriculture Committees in the House (Representatives Frank and Peterson) asserting that the legislative intent was for end users not to be subjected to margin and capital require-

ments. The letter also could be read as suggesting, in a statement relating to legal certainty for existing swaps, that margin requirements generally should not be imposed retroactively. However, that is not at all clear, given that the overall focus of the letter is on end users. Until the issue is definitively resolved by a technical corrections bill, rulemaking or both, there will be uncertainty as to both issues. Beyond that, the issues relating to potential retroactive effect for entities that become characterized as Major Participants are somewhat different and may not be fully addressed by any ultimate solution to the end user and margin issues.

Division of Regulatory Authority¹

The Act divides the regulation of the OTC derivatives market between “swaps” regulated by the CFTC and “security-based swaps” regulated by the SEC based on the characteristics of the underlying instrument or interest. The dividing line between the categories, however, is not entirely clear. Given that the characterization as one or the other type of swap has material consequences, both for compliance purposes and for potential liability under securities laws, it is hoped that these ambiguities will be adequately addressed in the rulemaking process.

Of greater concern, because it is less readily addressed, is the overlapping coverage among the various regulators — primarily the CFTC and SEC, but also the applicable bank regulators — who are charged with regulating various aspects of the derivatives markets. The complexity of the task and the potential jurisdictional conflicts make coordination essential, and such coordination is in fact mandated under the Derivatives Title. Subject to certain exceptions, such as those relating to orders in connection with a violation or potential violation of law, the SEC and the CFTC are required to consult and coordinate with each other and with the relevant “prudential regulators” (primarily the applicable federal bank regulators) before commencing rulemaking or issuing an order on the matters within their respective jurisdiction under the Derivatives Title, in order to ensure regulatory consistency and comparability to the extent possible.² In the near term, this could make it difficult to complete the rulemaking process within the required time frames. Longer term, it appears to pose a significant risk in that the regulatory process could be inefficient, potentially to the point of inhibiting new product development or obstructing the ability to effectively monitor and respond to systemic risks.

The appropriate federal banking regulator will have authority over derivatives-related capital and margin requirements for banks and bank holding companies as well as the rulemaking authority for the reporting and other compliance requirements applicable to the derivatives activities of those entities (including implementation and compliance with the Volcker Rule).

“Swap” is broadly defined to include most types of OTC derivatives, subject to a carve-out for “security-based swaps” and certain other specified exceptions.³ The definition (closely based on Section

¹ Act § 712.

² Act § 712(a). The SEC, CFTC and prudential regulators are also to consult and coordinate with foreign regulatory authorities (in this case, not of course as a condition to their own rulemaking) on the establishment of consistent international standards with respect to the regulation of swaps, security-based swaps, swap entities and security-based swap entities, to the end of achieving consistent international standards for their regulation. The CFTC is similarly required to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation of contracts of sale of a commodity for future delivery and options on such contracts. Act § 752.

³ Act § 721(a)(21) (to be codified at 7 U.S.C. § 1a).

206A of the Gramm-Leach-Bliley Act, as amended, the “GLB Act”) specifies a number of categories such as (i) puts, calls, caps, floors, collars or similar options of any kind that are for the purchase or sale, or based on the value of one or more interest or other rates, currencies, etc., and (ii) interest rate, currency, total return, equity, credit default, energy, metal, agricultural and commodity swaps, which, among others, are listed as examples of a broadly described category of risk transfer instruments. The definition also includes the broad catchall categories of “an agreement, contract or transaction that is or in the future becomes commonly known to the trade as a swap,” and any combination or permutation of, or option on, any of the described types.⁴

“Security-based swap”⁵ means any “swap” based on:

- an index that is a narrow-based security index, including any interest therein or on the value thereof;⁶
- a single security or loan, including any interest therein or on the value thereof; or
- the occurrence, nonoccurrence or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index; *provided* that such event directly affects the financial statements, financial condition or financial obligations of the issuer.⁷

The CFTC and the SEC will jointly prescribe rules and regulations for certain swaps, referred to as “mixed swaps,” that have characteristics of both “swaps” and “security-based swaps” and will be treated as security-based swaps.

The definition of “swap” excludes (and consequently “security-based swap” excludes), among other categories:

⁴The definition of “swap” also expressly includes any “security-based swap agreement” that meets the definition of “swap agreement” as defined in Section 206A of the GLB Act of which a material term is based on the price, yield, value or volatility of any security or any group or index of securities, or any interest therein (which is a description of how “security-based swap agreement” is defined in Section 206B of the GLB Act), and expressly excludes any “security-based swap” (other than a mixed swap) as defined in the Derivatives Title. It is not entirely clear why it was viewed as necessary to incorporate “security-based swap agreement” as defined in the GLB Act, because it is a subset of “swap,” as defined in the GLB Act, and therefore should be viewed as already included without being separately referenced. This may have been simply for avoidance of doubt as to inclusion.

⁵Act § 761(a)(6) (to be codified at 15 U.S.C. § 78c(a)).

⁶In general, subject to certain exceptions, “narrow-based security index” is defined in § 1a(25) of the CEA as an index of securities (i) that has nine or fewer component securities, (ii) in which a component security comprises more than 30% of the index’s weighting, (iii) in which the five highest weighted component securities, in the aggregate, comprise more than 60% of the index’s weighting; or (iv) in which the lowest weighted component securities comprising, in the aggregate, 25% of the index’s weighting have an aggregate dollar value of average daily trading volume of less than \$50 million, or in the case of an index with 15 or more component securities, \$30 million (subject to a specified adjustment if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted 25% of the index’s weighting).

⁷Among other issues that are not entirely clear in the definition is the treatment of an index of loans as opposed to securities. Additionally, while it appears that credit default swaps (other than those on broad-based security indices) are intended to be within the category of security-based swap, some commentators have raised the question whether so-called “pay-as-you-go” credit default swaps on asset-backed securities would fall within the definition of “security-based swap.” The question presumably is prompted by the proviso to the third clause of the definition, in which the events described are not intuitively descriptive of those that typically occur with respect to asset-backed securities.

- options on securities, or groups, or indices of securities, that are subject to the Securities Act and the Exchange Act;
- any contract of sale of commodities for future delivery (or option on such a contract);
- leverage contracts;
- security futures products; and
- certain physically settled forwards.

Foreign exchange swaps and foreign exchange forwards are to be considered “swaps” (within the jurisdiction of the CFTC) unless the Treasury makes a written determination that either or both should not be regulated as swaps under the Derivatives Title and are not structured to evade any rule promulgated by the CFTC under the Act.⁸ However, even if the determination is made not to regulate foreign exchange swaps or foreign exchange forwards as swaps, all such products must be reported to a swap data repository (or, if no swap data repository will accept such reporting, the CFTC), and any swap dealer or Major Participant (as defined below) that is a party to such a contract is subject to the business conduct standards under the Commodity Exchange Act (“CEA”) as amended by the Derivatives Title. Moreover, the exclusion from regulation as swaps, if made, would not exempt foreign exchange swaps or forwards that are listed and traded on or subject to the rules of a designated contract market or swap execution facility, or cleared by a derivatives clearing organization, from any provision of the CEA as amended by the Derivatives Title prohibiting fraud or manipulation, and would not affect the existing CFTC regulation of retail transactions.⁹

Many of the requirements set forth in the Act that apply to swaps regulated by the CFTC also apply to security-based swaps regulated by the SEC, including the requirements outlined in this article, except where otherwise indicated.¹⁰

⁸ Act § 721(a)(21) (to be codified at 7 U.S.C. § 1a).

⁹ See Act § 721(a)(21) (to be codified at 7 U.S.C. § 1a).

¹⁰ This article, except where otherwise indicated, uses the term “swap” to refer to both swaps and security-based swaps, and “swap dealer” to refer to both swap dealers and security-based swap dealers. The Act defines “[security-based] swap dealer” as:

(A) IN GENERAL, any person who — (1) holds itself out as a dealer in [security-based] swaps, (2) makes a market in [security-based] swaps, (3) regularly enters into [security-based] swaps with counterparties as an ordinary course of business for its own account or (4) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in [security-based] swaps [provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer].

(B) INCLUSION. — A person may be designated as a [security-based] swap dealer for a single type or single class or category of [security-based] swap or activities, and considered not to be a swap dealer for other types, classes, or categories of swaps or activities.

(C) EXCEPTION. — The term [security-based] “swap dealer” does not include a person that enters into [security-based] swaps for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

(D) DE MINIMIS EXCEPTION. — The [SEC/CFTC] shall exempt from designation as a [security-based] swap dealer an entity that engages in a de minimis quantity of [security-based] swap dealing in connection with transactions with or on behalf of its customers. The [SEC/CFTC] shall promulgate regulations to establish factors with respect to the making of this determination to exempt. See Act § 721(a)(21) (to be codified at 7 U.S.C. § 1a) (“swap dealer”) & Act § 761(a)(6) (to be codified at 15 U.S.C. § 78c(a)) (“security-based swap

Expanded Application of Securities Laws¹¹

Since the passage of the Commodity Futures Modernization Act of 2000 (the “CFMA”), the anti-fraud and anti-manipulation provisions of the Securities Act and the Exchange Act as well as the insider-trading provisions of the Exchange Act have applied to “security-based swaps” (as defined in Section 206B of the GLB Act). However, the GLB Act prohibited the SEC from otherwise regulating security-based swaps. Section 762 under the Derivatives Title repeals the provisions enacted under the GLB Act and the CFMA that prohibited the SEC from regulating security-based swaps and significantly expands the regulation of security-based swaps under the Securities Act and the Exchange Act.

The Derivatives Title amends the definition of “security” for purposes of the Exchange Act to include “security-based swaps.”¹² The Derivatives Title also effects numerous other amendments to the Exchange Act including (in addition to the clearing and reporting requirements with respect to security-based swaps) subjecting security-based swaps to the prohibition on the manipulation of security prices under Section 9 of the Exchange Act,¹³ and adding a new Section 10B of the Exchange Act that authorizes the SEC to set limits on the size of positions in any security-based swap that may be held by any person.¹⁴

Also noteworthy are the amendments to Section 13 of the Exchange Act relating to beneficial ownership reporting and short-swing profit recovery. Sections 13(d)(1), 13(f)(1) and 13(g)(1) of the Exchange Act — relating to required disclosure of acquisition of more than 5% beneficial ownership interests and quarterly reporting by institutional investment managers — are amended to provide that certain security-based swaps (as provided in rulemaking by the SEC) may be deemed to constitute beneficial ownership of a registered class of equity securities for purposes of the reporting requirements.¹⁵ The Derivatives Title also adds a new subsection 13(o) to the Exchange Act which provides — for purposes of Sections 13 and 16, relating to disclosure and short-swing profit recovery for directors, officers and beneficial owners of more than 10% — that beneficial ownership of the security underlying a security-based swap may be deemed to have been acquired if the SEC determines that the security-based swap provides incidents of ownership comparable to direct ownership (and that it is necessary to achieve the purposes of Section 13 of the Exchange Act that those swaps be deemed the acquisition of beneficial ownership of the related security). The amendments also give the SEC the authority to require more timely, and frequent, reporting of beneficial ownership interests.

The Derivatives Title sets forth amendments to the Securities Act that, among other things:

- add security-based swap to the definition of “security” under Section 2(a)(1) of the Securities Act;
- provide that the offer or sale of a security-based swap by or on behalf of the issuer of the referenced securities (or an affiliate of the issuer, or an underwriter) constitutes a contract for the sale of or offer to sell the referenced securities under Section 2(a)(3) of the Securities Act; and

dealer”). The bracketed proviso in clause (A) above is included in the definition only of “swap dealer,” but not “security-based swap dealer.”

¹¹Act §§ 761 (to be codified at 15 U.S.C. 78c(a)), 762, 763 (to be codified at 15 U.S.C. 78a *et seq.*), 766 (to be codified at 15 U.S.C. 78a *et seq.*) & 768 (to be codified at 15 U.S.C. 77b(a)).

¹²Act § 761 (to be codified at 15 U.S.C. 78c(a)).

¹³Act § 763(f) (to be codified at 15 U.S.C. 78a *et seq.*).

¹⁴See “Position Limits” below.

¹⁵Act § 766(b) (to be codified at 15 U.S.C. 78m).

- subject security-based swaps to the registration requirement of Section 5 of the Securities Act¹⁶ unless the counterparty to the security-based swap is an “eligible contract participant”¹⁷ as defined under the Commodity Exchange Act (the “CEA”).

The treatment of security-based swaps as securities under the Securities Act and the Exchange Act raises questions regarding the extent to which rules and regulations under those Acts, beyond those expressly made applicable to security-based swaps, may apply to security-based swaps. This is of particular concern in view of the lack of clarity as to whether certain types of swaps — which may include certain “bespoke” portfolio swaps used in structured finance transactions and “pay-as-you-go” swaps on asset-backed securities — will be treated as “swaps” or as “security-based swaps.”

Mandatory Clearing and Exchange Trading Requirements¹⁸

As noted above, the main objectives of the derivatives legislation are to bring transparency to the market for the types of derivatives transactions that have been privately negotiated bilateral trades in the OTC market, and to reduce the potential for counterparty and systemic risk of those products. In addition to the enhanced regulation of financial institutions and other major market participants, the primary means of achieving those goals are to require that the transactions occur on trading platforms — designated contract markets or swap execution facilities for CFTC-regulated products, and security-based swap execution facilities or national securities exchanges for SEC-regulated products — in order to provide transparency to the market, and that the transactions receive the credit protections afforded by clearinghouses regulated by the CFTC or SEC, as applicable.

In general, a clearing organization or clearing agency (also referred to as a clearinghouse, or a central clearing platform) is a member-funded organization that acts as an intermediary in clearing and settling trades and netting offsetting transactions. A clearinghouse typically is relied upon to insulate those trading with it from a default by a member or other counterparties by requiring contributions from its members to serve as a reserve, and to collect margin on each transaction from members and others who trade through it. In the context of commodities and swaps, the clearinghouse collects upfront and mark-to-market collateral (typically referred to in the swap context as “initial” and “variation” margin). The clearing provisions of the Derivatives Title are premised on an expectation that use of the clearinghouse model will reduce counterparty and systemic risk in the newly regulated OTC derivatives market.¹⁹

¹⁶Act § 768 (to be codified at 15 U.S.C. 77b(a)).

¹⁷An “eligible contract participant” is defined under the CEA to mean a person, acting for its own account, that is a financial institution, an insurance company, an investment company, a commodity pool, a corporation or other legal entity, an employee benefit plan, a government entity, or certain other types of entities and individuals, in each case having a minimum required total assets, net worth or total amount invested, as applicable, or meeting other specified requirements.

Section 721(a)(9) (to codified at 7 U.S.C. 1a) under the Derivatives Title amends the existing definition of “eligible contract participant” by:

(1) raising from \$25 to \$50 million the threshold amount required to be owned and invested on a discretionary basis for qualification by a governmental entity, political subdivision, multinational or supranational government entity, or instrumentality, agency or department of any of such entities, and,

(2) requiring individuals to have “amounts invested on a discretionary basis” (as opposed to “total assets,” under the current definition) in excess of \$10 million (or \$5 million if the contract is entered into to manage a risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred by the individual).

¹⁸Act §§ 723 (to be codified at 7 U.S.C. 2) & 763 (to be codified at 15 U.S.C. 78a *et seq.*).

¹⁹Demonstrating the importance of clearing in the legislative framework, the Derivatives Title provides that any

General Rule. The Act requires swaps to be cleared if they are of a type that the CFTC or SEC, as applicable, determines must be cleared and they are accepted for clearing by a “derivatives clearing organization” (a “DCO”) (in the case of a swap) or a clearing agency (in the case of a security-based swap) unless one of the exemptions described below applies. The regulatory review process for a particular group, category, type or class of swap can be initiated either by a DCO or clearing agency, or by the relevant regulator.

Any DCO or clearing agency is required to submit to the CFTC or SEC, respectively, each swap, or any group, category, type or class of swap that the DCO or clearing agency plans to accept for clearing, and provide notice of the submission to its members. The CFTC or SEC will make such submissions available to the public, make its determination as to whether clearing is required, and provide at least a 30-day public comment period regarding its determination. The determination is to be made by the CFTC or SEC within 90 days following the submission, unless the submitting DCO or clearing agency agrees to an extension.²⁰ However, the CFTC or SEC, on application of a counterparty to a swap or on its own initiative, may stay the clearing requirement after issuance of such an approval until the CFTC or SEC completes a review of the terms of the swap (or the group, category, type or class of swap) and the clearing arrangement. The review is to be completed within 90 days following the issuance of the stay, again, unless the submitting DCO or clearing agency agrees to an extension. Upon completion of the review, the CFTC or SEC may determine, unconditionally or subject to such conditions as it determines, that the swap, or group, category, type or class of swap, must be cleared, or that the clearing requirement will not apply.

It may not be possible for the CFTC or SEC to address all applications for approval or stays of the clearing requirements on a timely basis if the volume of applications is significant. This could be an issue during the rulemaking period and probably for a significant length of time thereafter, when clearinghouses and counterparties will be eager to determine the status of various products.

The CFTC or SEC also may itself initiate review of any group, category, type or class of swap to determine whether mandatory clearing should apply. The same time frames, including the 30-day public comment period, apply to the regulator-initiated review, except that the stay process does not apply.

Swaps subject to the clearing requirement also must be traded on a board of trade designated as a contract market or a swap execution facility (in the case of a swap) or on a security-based swap execution facility or a national securities exchange (in the case of a security-based swap), unless no relevant facility will make the particular swap available to trade (or, in the case of certain exempt end users, described below, if the end user opts to exercise its clearing exemption). However, uncleared swaps will be subject to the reporting and recordkeeping requirements for uncleared swaps described below under **“Reporting and Recordkeeping Requirements for Uncleared Swaps.”**

Entering into cleared transactions will require swap counterparties to post initial margin and to post (or receive returns of) variation margin at least daily, and potentially on additional occasions, intraday. For

DCO or clearing agency that knowingly or recklessly evades or participates in or facilitates an evasion of the clearing requirements under the Act will be liable for a civil money penalty in twice the amount otherwise available for a violation of the relevant provisions of the CEA or the Exchange Act, as applicable. Act §§ 741(b) (to be codified at 7 U.S.C. 6b) & 773 (to be codified at 15 U.S.C. 78p-2).

²⁰Any swap and any group, category, type or class of swap that is already listed for clearing by a DCO or a clearing agency on the date of enactment of the Act will be considered to be submitted to the CFTC and/or SEC for approval for clearing.

swap users that have been sufficiently creditworthy not to post margin in the OTC market, or to have posted margin in lesser amounts than may be required by DCOs or clearing agencies once the clearing requirements become effective, the change in margin requirements could reduce available liquidity and effectively increase the cost of hedging or otherwise using derivatives.²¹ These swap users may see offsetting benefits, however, in terms of increased pricing transparency and liquidity.

One of the many thorny transitional issues to be resolved is whether it will be possible for members of more than one DCO or clearing agency to obtain the benefits of netting and margin posted not only across products, but also across clearing platforms. DCOs have the benefit of a provision that “in order to minimize systemic risk, under no circumstances shall a derivatives clearing organization be compelled to accept the counterparty credit risk of another clearing organization.”²² But a clearing organization is not prohibited from doing so. The benefits to members would be evident, but such arrangements could be legally and operationally complex.

The clearing requirement under the Derivatives Title²³ has no explicit transition period; therefore, the General Effective Date provision applies, subject to the additional practical consideration that many products will not have been approved for clearing for some time after the General Effective Date.

Exemption for Certain End Users. A swap will be exempt from the clearing and exchange trading requirements described above if one of the counterparties to the swap is an end user (as defined below) that is hedging its own commercial risk. The end user can elect to require the swap to be cleared and traded on an exchange or swap execution facility even if the exemption is available.

By definition, an end user cannot be a financial entity (as defined below). The exemption applies only to a swap counterparty that “(i) is not a financial entity; (ii) is using swaps to hedge or mitigate financial risk, and (iii) notifies the [CFTC or SEC], in a manner set forth by the [CFTC or SEC], how it generally meets its financial obligations associated with entering into non-cleared swap.”²⁴

“Financial entity” means any of the following:

- A swap dealer or a Major Participant (as defined below for purposes of this article);
- A commodity pool as defined in the CEA;
- A private fund as defined in Section 202(a) of the Investment Advisers Act (a fund that would be required to register as an investment company but for the exemption provided by Sections 3(c)(1) or 3(c)(7) of the 1940 Act);²⁵
- An ERISA plan; or

²¹In addition to the increased out-of-pocket and opportunity costs of meeting increased margin requirements, many companies simply may not have a treasury function that is equipped to readily handle daily or intraday posting requirements, and may need to turn to banks to provide these treasury services, coupled with lines of credit to cover margin calls.

²²Act § 725(h) (to be codified at 7 U.S.C. 7a-1(F)(i)).

²³Act §§ 723(h) (swaps) (to be codified at 7 U.S.C. 7a-1(F)(i)) & 763(a) (security-based swaps) (to be codified at 15 U.S.C. 78a *et seq.*).

²⁴Act §§ 723(a)(3) (to be codified at 7 U.S.C. 2) & 763(a) (to be codified at 15 U.S.C. 78a *et seq.*).

²⁵“Private fund” is newly defined in Section 402 of the Act (to be codified at 15 U.S.C. 80b-2(a)). Given this definition, most CDOs and many other types of SPEs and investment funds will be financial entities for purposes of the Derivatives Title.

- A person predominantly engaged in activities that are in the business of banking or financial in nature.²⁶

For purposes of the clearing exemption for end users of swaps, the term “financial entity” expressly excludes captive finance companies that meet the following standard: an entity whose primary business is providing financing, and which uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent company or another subsidiary of the parent company.²⁷

The CFTC or SEC, as applicable, is to consider whether to exempt small banks, savings associations, farm credit system institutions and credit unions with total assets not exceeding \$10 billion.

An affiliate of an end user — including an affiliate predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the end user — may rely on the end-user exemption only if the affiliate, acting on behalf of the end user and as an agent, uses the swap to hedge or mitigate the commercial risk of the end user or other affiliate of the end-user that is not a “financial entity.” However, the affiliate may not rely on the end-user exemption if it is a swap dealer, a Major Participant, an issuer that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the 1940 Act, a commodity pool or a bank holding company with more than \$50 billion in consolidated assets.

A transitional exemption is also provided for an affiliate, subsidiary or wholly owned entity of an end user that is predominantly engaged in providing financing for the purchase or lease of merchandise or manufactured goods of the end user. Such entities are exempt from the clearing requirement and from margin requirements with regard to swaps, or security-based swaps, entered into to mitigate the risk of the financing activities for not less than a two-year period following enactment. This clause appears to be intended to ease the transition for end users whose captive finance companies have activities that will not fit the strict standard for the exclusion from “financial entity.” Certainly those using security-based swaps for hedging purposes would not meet the terms of that exclusion.

The CFTC or SEC, as applicable, may promulgate rules and regulations to prevent abuses of the end user exemption.

An end user that is an issuer of securities registered under Section 12 of the Exchange Act or that is required to file reports under Section 15(d) of the Exchange Act may rely on the end user exemption only if an appropriate committee of the issuer’s board of directors or governing body has reviewed and approved its decision to enter into swaps that are uncleared in reliance on that exemption. It is not clear on the face of the provision whether that review and approval could be on a blanket basis or whether more specific approvals will be required.

Exemption From Clearing for Grandfathered Swaps. Swaps entered into prior to enactment (or post-enactment, but prior to the effective date of the clearing requirement) will not be subject to the clearing or exchange trading requirements but will be subject to the reporting and recordkeeping requirements for uncleared swaps described below.

²⁶“Financial in nature” is as defined in Section 4(k) of the BHCA.

²⁷No parallel exclusion is made for purposes of the clearing exemption in respect of security-based swaps, presumably reflecting an assumption that the hedging instruments typical of the activities of a captive finance company would include interest rate and currency hedges.

Definitions of Major Swap Participant/Major Security-Based Participant²⁸

The Act uses the term “Major Swap Participant” (“MSPs”) to refer to a participant in swaps regulated by the CFTC and “Major Security-Based Swap Participant” (“MSSPs”) to refer to a participant in a security-based swap regulated by the SEC. For purposes of this article, the term “Major Participant” will be used to refer to both MSPs and MSSPs. An entity may be both an MSP and an MSSP for purposes of the Derivatives Title. Major Participants are subject to the regulatory and compliance requirements under the Act described in this article.

A Major Participant is any entity that is not a swap dealer and that satisfies any one of the following alternative conditions:

- It maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC or SEC, excluding positions held for hedging or mitigating commercial risk (or hedging or mitigating any risk directly associated with the operation of an ERISA plan);
- Its outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
- It is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate federal banking agency, and it maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC or SEC.

The definitions of MSP and MSSP are identical in substance, except that only the definition of MSP expressly excludes captive finance companies that meet the following standard (which by its terms is not relevant to the swaps done by an MSSP, in its capacity as such):²⁹ an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent company or another subsidiary of the parent company.

The CFTC or SEC, as applicable, is to define “substantial position” (for purposes of the first and third categories of entities described above) at a threshold it determines prudent for the monitoring, management and oversight of entities that are systemically important or can significantly impact the financial system of the U.S.³⁰ In setting the threshold, the CFTC or SEC is required to consider the person’s relative position in uncleared as opposed to cleared swaps, and may take into consideration the value and quality of collateral held against counterparty exposures. The language of the Derivatives Title does not indicate whether the threshold will be the same for all types of swaps; *i.e.*, it appears it could vary by type of swap or type of entity. In addition, an entity may be designated as either an MSP or MSSP for one type of swap or security-based swap, respectively, without being an MSP or MSSP for all swaps or security-based swaps.³¹

²⁸Act §§ 721 (to be codified at 7 U.S.C. 1a) & 761 (to be codified at 15 U.S.C. 78c(a)).

²⁹As noted above in connection with discussion of the term “financial entity,” this appears to reflect a legislative assumption regarding the appropriate hedging instruments for captive finance companies.

³⁰There is also no definition of “highly leveraged” or certain other concepts used in the definition, all of which are expected to be defined in the rules and regulations to be promulgated by the CFTC or SEC.

³¹The provision refers to an entity being “designated,” which may suggest that the CFTC or SEC, as

Mandatory Registration, Capital and Margin Requirements³²

The Act requires swap dealers and Major Participants to register with the CFTC or SEC not later than one year after enactment, and to satisfy capital and initial and variation margin requirements to be established within the same period by the applicable regulatory authority. The CFTC or SEC will set capital and margin requirements for nonbank swap dealers and nonbank Major Participants that are required to register. The appropriate federal banking agency will set the capital and margin requirements for banks that are required to register as swap dealers or Major Participants. A separate time frame for promulgating the rules and regulations specifying the capital and margin requirements is not set forth in the Derivatives Title; accordingly, the general rule requiring the rules and regulations be promulgated within 360 days following passage of the legislation applies.

The CFTC or SEC and the appropriate federal banking authorities are required to consult periodically (but not less frequently than annually) as to the appropriate required capital and margin requirements. In setting capital requirements for an entity designated as a Major Participant for a single type of swaps, the applicable regulatory authority is required to take into account the risks associated with other types of swaps engaged in and the other activities conducted by that entity that are not otherwise subject to regulation by virtue of the status of that entity as a Major Participant. The margin requirements to be set by the CFTC or SEC or the appropriate federal banking agency, as applicable, for swap dealers and Major Participants apply only to uncleared swaps (*i.e.*, the DCO or clearing agency requirements will apply to cleared swaps). Noncash collateral may be permitted to satisfy margin requirements but the use of noncash collateral for that purpose may be restricted by the applicable regulatory authority.

While the actual capital and margin requirements are still unknown, there are indications that they will be significant, and likely higher than the requirements imposed in connection with cleared swaps. The relevant language explicitly refers to the need to “offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared,” and that the requirements shall “(i) help ensure the safety and soundness of the swap dealer or major swap participant; and (ii) be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant.”³³

The higher capital requirements imposed on swap dealers and Major Participants in connection with uncleared swaps are likely to be reflected in the cost to their counterparties of entering into such swaps. Uncleared swaps also may be generally less liquid than cleared swaps. The combination of higher costs associated with uncleared swaps and reduced liquidity may adversely affect SPEs and other investment vehicles because, for the following reasons, SPEs generally are unlikely to obtain the benefits of clearing. Swaps entered into by SPEs typically are tailored to the particular structure, and even the interest rate and foreign exchange swaps entered into by SPEs and other investment vehicles

applicable, would review data submitted by swap counterparties and designate those that are MSPs or MSSPs, respectively, and as to which types of swaps or security-based swaps, as opposed to entities being required to register, or not, based on their analysis of criteria to be set by the CFTC and SEC relative to their derivatives positions. If it really is intended that only “designated” entities will be Major Participants, that is a further indication that the “substantial position” threshold will be very high; otherwise, that review and designation process alone could swamp the regulators.

³²Act §§ 731 (to be codified at 7 U.S.C. 1 *et seq.*) & 764 (to be codified at 15 U.S.C. 78a *et seq.*).

³³Act §§ 731 (to be codified at 7 U.S.C. 1 *et seq.*) & 764 (to be codified at 15 U.S.C. 78a *et seq.*).

may not be considered sufficiently “standard” to be cleared on an exchange. Additionally, unless differently structured in the future, SPEs would be unlikely to have sufficient available funds to post margin in the manner that is required in connection with a cleared swap.³⁴ Accordingly, though it is too early to predict with any certainty, it seems likely that for structured finance vehicles the new regime will have few benefits, other than the likely availability of better pricing data, and could have increased costs. To some extent, although not to the same degree, this outcome also may be typical of any market participants — other than end users — that for various reasons desire or need to do “bespoke” derivatives.³⁵

Mandatory Reporting and Other Mandatory Compliance Requirements³⁶

The Derivatives Title requires swap dealers and Major Participants generally to comply with:

- significant financial reporting, annual compliance reporting and other reporting requirements;
- significant recordkeeping requirements;
- business conduct standards; and
- documentation and back office standards to be set forth in rules and regulations promulgated under the Derivatives Title.³⁷

Swap dealers and Major Participants also are required to perform certain duties, including:

- monitoring trading;
- establishing risk management procedures;
- disclosing certain information to regulators;
- establishing systems and procedures to obtain necessary information;
- implementing conflicts of interest procedures;
- avoiding anticompetitive practices; and
- appointing a chief compliance officer whose duties will include regulatory reporting.³⁸

These mandatory reporting and other mandatory compliance requirements apply to “registered” swap dealers and Major Participants. Registration in those capacities must be made not later than one year after the enactment date.

³⁴It would be far more common for an SPE to have its assets pledged to a trustee or collateral agent for the benefit of all secured creditors in accordance with a priority of payments, than to have large amounts of free cash available to be exclusively dedicated to a single counterparty.

³⁵This assumes that the issue of margin requirements for end users is clarified, as discussed above.

³⁶Act §§ 731 (to be codified at 7 U.S.C. 1 *et seq.*) & 764 (to be codified at 15 U.S.C. 78a *et seq.*).

³⁷Act §§ 731 (to be codified at 7 U.S.C. 1 *et seq.*) & 764 (to be codified at 15 U.S.C. 78a *et seq.*).

³⁸*Id.*

Reporting and Recordkeeping Requirements for Uncleared Swaps³⁹

Uncleared swaps are required to be reported to a swap data repository (as described below) or to the CFTC or SEC if a swap data repository is unavailable. For swaps entered into on or after the date of enactment, this reporting is to be done within a period of time after entering into the swap that the CFTC or SEC is to prescribe by rule or regulation. Pre-enactment swaps also must be reported to a swap data repository or to the CFTC or SEC if a swap data repository is unavailable. However, the Derivatives Title has overlapping and inconsistent provisions addressing this reporting. Under one set of provisions, the deadline for such transitional reporting is no later than 30 days after the effective date of the “interim final rule” (which in turn is required to be finalized within 90 days following enactment) or such other period as the CFTC or SEC determines to be appropriate. Another set of provisions specifies a later date, following the General Effective Date, for each of pre-enactment and post-enactment swaps. These disparities presumably will be addressed by a technical corrections bill or by rulemaking.

It appears that, in general, uncleared swaps are to be reported by, if the transaction involves only one swap dealer or Major Participant, the swap dealer or Major Participant (as applicable), or, if the transaction involves both a swap dealer and a Major Participant, the swap dealer. In all other swaps, the counterparties must choose a reporting party. However, one of the sets of provisions addressing reporting of swaps and security-based swaps, respectively, does not so provide.

If a swap is not cleared or accepted by a swap data repository, each counterparty must maintain books and records available to regulators on the swaps and, if requested in writing by the CFTC or SEC, provide reports as required by the CFTC or SEC. The reports will be open for inspection by the CFTC or SEC, the appropriate prudential regulator (as defined in the Act), and the Council.⁴⁰

Public Reporting of Swap Transaction Data⁴¹

The Act requires the CFTC or SEC to promulgate rules and regulations for “real-time public reporting” of swap transaction and pricing data in such form and such times as the CFTC or SEC determines appropriate to enhance price discovery. “Real-time public reporting” is defined as the reporting of data relating to a swap transaction, including price and volume, as soon as technologically practicable after execution for swaps. Real-time public reporting will apply to swaps that are subject to the mandatory clearing requirement described above (including those that are exempted from the requirement pursuant to the end user exemption), and swaps that are not subject to the mandatory clearing requirement but are cleared by a registered DCO or clearing agency. For pre-enactment swaps (and post-enactment swaps entered into prior to the effective date of the clearing requirement) that are not cleared at a registered DCO or clearing agency, and are reported to a swap data repository or to the CFTC or SEC, the applicable regulator will require real-time public reporting of such transactions in a manner that does not disclose the business transactions and market positions of any person.

³⁹Act §§ 729 (to be codified at 7 U.S.C. 6o–1) & 766 (to be codified at 15 U.S.C. 78a *et seq.*).

⁴⁰While an SPE is not likely to be responsible for the swap data repository reporting requirements under Sections 729 (to be codified at 7 U.S.C. 6o–1) and 766 (to be codified at 15 U.S.C. 78a *et seq.*) (because most swaps entered into by SPEs that are not themselves Major Participants are likely to have a counterparty that is a swap dealer or a Major Participant, who would be the reporting party), SPEs, like any other party to an uncleared swap, will have to comply with the books and recordkeeping requirements for uncleared swaps.

⁴¹Act §§ 727 (to be codified at 7 U.S.C. 2(a)) & 763(i) (to be codified at 15 U.S.C. 78a *et seq.*).

The CFTC or SEC is required to include provisions to ensure that participants are not identified and to specify criteria for determining what constitutes a large notional swap transaction (block trade) for particular markets in order to institute appropriate time delays of the reporting of such transactions. In promulgating these rules and regulations, the SEC or CFTC is required to take into account whether public disclosure would materially reduce market liquidity.

The CFTC or SEC may require registered entities to publicly disseminate the swap transaction and pricing data information required pursuant to this provision. The CFTC or SEC will issue semiannual and annual reports on the trading and clearing of major swap categories and the market participants and development of new products.

Swap Data Repositories⁴²

The Derivatives Title requires swap data repositories to accept data from swap counterparties, confirm the accuracy of that data and maintain the data pursuant to standards to be established by the CFTC or SEC, including direct electronic access to the CFTC or SEC and systems for monitoring and analyzing data and making information available to regulators. Swap data repositories are required to register with the CFTC or SEC and to make available on a confidential basis all data obtained by the swap data repository, including individual counterparty trade and position data, to each appropriate prudential regulator, the Council, the SEC, the DOJ, any other person that the CFTC or SEC determines to be appropriate, including foreign financial supervisors (including foreign futures authorities), foreign central banks and foreign ministries, and to establish and maintain emergency procedures, backup facilities, and a plan for disaster recovery that allows for the timely recovery and resumption of operations and the fulfillment of the responsibilities and obligations of the organization.

Position Limits⁴³

The Act authorizes the CFTC to impose aggregate position limits across markets, in order to (i) diminish, eliminate, or prevent excessive speculation; (ii) deter and prevent market manipulation, squeezes, and corners; (iii) ensure sufficient market liquidity for bona fide hedgers; and (iv) ensure that the price discovery function of the underlying market is not disrupted. Swap positions entered into prior to enactment will be exempt from the position limits imposed by the CFTC.⁴⁴

The SEC, for the purpose of preventing fraud and manipulation, may establish limits on the size of positions in any security-based swap that may be held by any person, and may require reporting by such persons.⁴⁵ For that purpose, positions in security-based swaps may be required to be aggregated with positions in the securities or loans that the security-based swap is based upon or references or to which it is related, or any group or index of securities that is the basis for a material term of the security-based swap, or any other instrument relating to the same security or group or index of securities. The SEC also may direct self-regulatory organizations to impose similar requirements with respect to its members or their customers.

⁴²Act §§ 728 (to be codified at 7 U.S.C. 24) & 763(i) (to be codified at 15 U.S.C. 78a *et seq.*).

⁴³Act §§ 737 (to be codified at 7 U.S.C. 6a(a)) & 763 (to be codified at 15 U.S.C. 78a *et seq.*).

⁴⁴Act § 739 (to be codified at 7 U.S.C. 25(a)).

⁴⁵Act § 763(h) (to be codified at 15 U.S.C. 78a *et seq.*).

Segregation of Swap Collateral; Bankruptcy Treatment of Swaps⁴⁶

Any person that holds margin for DCO-cleared swaps for customers is required to register with the CFTC as a futures commission merchant (“FCM”). Any person that holds margin for clearing agency-cleared swaps for customers is required to be registered with the SEC as a broker-dealer or security-based swap dealer. The FCM (in the case of a swap) or the broker-dealer or security-based swap dealer (in the case of a security-based swap) is required to segregate property held as margin. The use and investment of segregated funds will be subject to such rules as the CFTC or SEC, as applicable, may promulgate.

The Act provides that a swap cleared through a DCO will be treated as a “commodity contract” for purposes of the U.S. Bankruptcy Code with respect to funds and property of a swap customer received by an FCM or a DCO (*i.e.*, posted margin). The evident intent of this provision is to provide the preferential treatment of such funds and property in the event of the insolvency of the FCM in the same manner that Section 766 of the Bankruptcy Code treats margin posted in respect of commodity contracts in the event of an insolvency of an FCM.

Margin posted by counterparties to “security-based swaps” will be held in a “securities account” by a broker, dealer or security-based swap dealer registered with the SEC. These accounts would be subject to the liquidation procedures applicable to broker-dealers in the event of insolvency.

Uncleared swaps are not subject to the above statutory requirements. However, with respect to uncleared swaps entered into with a swap dealer or a Major Participant, the swap dealer or Major Participant must notify the counterparty at the commencement of a swap transaction that the counterparty is entitled to require the segregation of funds or other property posted as initial margin. If the counterparty so elects, then the swap dealer or Major Participant must, in accordance with such rules and regulations as the CFTC or SEC may promulgate, maintain any initial margin posted by its counterparty in a segregated account separate from the assets and other interests of the swap dealer or Major Participant. If the counterparty does not require funds to be segregated, the swap dealer or Major Participant must report to the counterparty on a quarterly basis that the back office procedures of the swap dealer or Major Participant relating to margin and collateral requirements are in compliance with the agreement of the counterparties. This option of the counterparty does not apply to variation margin.

Legal Certainty for Swaps⁴⁷

The Act contains an amendment to Section 22(a) of the CEA, entitled “Legal Certainty for Swaps,” intended to remove doubt as to the legality or enforceability of contracts newly subject to regulation that may not meet certain requirements, including clearing requirements, under the CEA. The provision further provides, with express reference to long-term swaps entered into prior to enactment of the Derivatives Title, that neither the enactment nor any provision or requirement of the Derivatives Title will constitute “a termination event, force majeure, illegality, increased costs, regulatory change, or similar event under a swap (including any related credit support arrangement) that would permit a party to terminate, renegotiate, modify, amend, or supplement one or more transactions under the swap.”

This provision may have the intended effect of providing parties to pre-enactment swaps with some protection against having their swaps summarily terminated or pricing changed on the basis that

⁴⁶Act §§ 724 (to be codified at 7 U.S.C. 6d) & 763 (to be codified at 15 U.S.C. 78a *et seq.*).

⁴⁷Act § 739 (to be codified at 7 U.S.C. 25(a)).

passage of the Act constitutes a change of law or other termination event, or triggers an increased costs provision. However, it leaves important questions unanswered. Notably, there is no parallel provision for security-based swaps. Therefore, for those who view the provision as beneficial, the protections are not expressly given to the SEC-regulated products. In addition, an entity that is unable to comply with new requirements (should any be imposed retroactively), which otherwise may have had the ability to rely on a termination provision to terminate at a mid-market price, instead may be effectively compelled to seek a negotiated termination to avoid costs or penalties. Other parties (not only swap dealers) may be deprived of the right to exercise termination or renegotiation rights upon which they would expect to rely if subjected to higher costs or other adverse consequences of changes in law or regulation.

Ban on Proprietary Trading of Derivatives for Bank's Own Account⁴⁸

The Volcker Rule could have far-reaching consequences for the conduct of derivatives activities by banking organizations. The provision prohibits insured depository institutions and their affiliates from engaging in "proprietary trading," except as otherwise provided. For these purposes, "proprietary trading" is defined as engaging as a principal for the trading account⁴⁹ of the relevant entity to purchase or sell, or otherwise acquire or dispose of, any security, derivative, contract of sale of a commodity for future delivery, option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate federal banking agencies, the SEC and the CFTC may, by rule, determine. Exclusions from the prohibition include certain underwriting and market-making activities; risk-mitigating hedging activities in connection with positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such positions, contracts or other holdings; and purchases and sales on behalf of customers.⁵⁰

The implementation and effectiveness of the Volcker Rule is subject to a post-enactment study by the Council, which is to make recommendations on implementation within six months following enactment, after which a nine-month period of rulemaking by the federal bank regulators as well as the SEC and CFTC commences. The Volcker Rule is to become effective on the earlier of one year after the adoption of the final agency rules and two years after the enactment of the Act. Following that effective date, there is a transition period of up to two years, after which the FRB has the discretion to grant up to three one-year extensions. **See "The Volcker Rule."**

⁴⁸Act § 619 (to be codified at 12 U.S.C. 1841 *et seq.*).

⁴⁹"Trading account" is defined in § 619 (to be codified at 12 U.S.C. 1841 *et seq.*) as any account used for acquiring or taking positions in the relevant securities and instruments principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the appropriate Federal banking agencies, the SEC, and the CFTC may, by rule, determine.

⁵⁰Also excluded from the prohibition are the purchase, sale, acquisition, or disposition of U.S. government or agency obligations, obligations of any State or political subdivision thereof, and obligations of or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971.

The Lincoln Provision (Swaps “Push-Out” by Banks)⁵¹

The Act also includes a controversial provision that prohibits “federal assistance” to any “swaps entity.” Federal assistance is defined for this purpose as the use of advances from any Federal Reserve credit facility or discount window (that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act; *i.e.*, the emergency lending powers), or FDIC insurance or guarantees for a number of specified purposes relating to a swaps entity, including making any loan to a swaps entity, purchasing the assets of a swaps entity, or guaranteeing any loan or debt issuance of a swaps entity. “Swaps entity” is defined as any swap dealer or Major Participant that is registered under the CEA or the Exchange Act, other than a Major Participant that is an insured depository institution. Therefore, an insured depository institution will be a “swaps entity” for purposes of this provision only if it is a swap dealer.

Although substantially moderated in the House-Senate Conference, this provision (referred to herein as the “Lincoln Provision”) effectively requires any bank or other entity with access to Federal Reserve credit or FDIC assistance, and whose derivatives activities constitute acting as a swap dealer, to cease (after a transition period) all swap activities other than those expressly permitted to be conducted within an insured depository institution, as described below. An insured depository institution is permitted to have or establish an affiliate that is a swaps entity, but only if the insured depository institution is part of a bank holding company, or savings and loan holding company, that is supervised by the Federal Reserve, and the swaps entity affiliate complies with sections 23A and 23B of the Federal Reserve Act and such other requirements as the CFTC or SEC, as appropriate, and the Board of Governors, may determine to be necessary. In addition, such an entity would have to independently meet the capital and other requirements imposed by the Derivatives Title to act as a swap dealer, as well as independently satisfying any other standards required as a practical matter to participate in the market, such as requirements of clearing organizations and of counterparties who will only transact with swap providers that have high counterparty ratings. To separately capitalize such an affiliate at the level necessary for it to satisfy those regulatory and market standards may be unfeasible for all but the largest banking organizations. The Lincoln Provision also expressly provides that an insured depository institution is required to comply with the limitation on proprietary trading of derivatives under the Volcker Rule (which should have been clear on the face of the Volcker Rule, without such an additional provision). The combined effect of the Lincoln Provision and the Volcker Rule is to substantially limit the derivatives activities of insured depository institutions and their affiliates, even those conducted in a separate “swaps entity.”

As modified in Conference, the Lincoln Provision permits an insured depository institution to engage in (i) hedging and other similar risk mitigating activities directly related to the insured depository institution’s activities and (ii) acting as a swaps entity for swaps involving rates or reference assets that are permissible for investment by a national bank under the National Bank Act. However, the second permitted category is limited with respect to credit default swaps (including on asset-backed securities) to only those cleared by a DCO or a clearing agency. Taken as a whole, this provision would appear to permit insured depository institutions to engage in interest rate swaps, foreign exchange swaps, gold and silver swaps and cleared credit default swaps referencing investment grade securities, but not other derivatives (except to the extent constituting hedging activities).

⁵¹Act § 716.

Because the Lincoln Provision expressly refers only to insured depository institutions as being exempt (to the extent specified) from the general ban on federal assistance to swaps entities, the provisions relating to the permitted activities (and those relating to the transition period) do not on their face apply to U.S. branches of foreign banks. This distinction appears likely to have been an oversight, and it may be an appropriate subject for the contemplated technical corrections bill that was discussed in the final stages of the House-Senate Conference.

The Lincoln Provision seeks to assure no losses to taxpayers through bank swaps activities, by requiring (i) the liquidation of FDIC insured institutions or nonbank financial institutions regulated by the Board of Governors that are put into receivership or declared insolvent as a result of swap or security-based swap activity (a formulation that evidently assumes direct causation would be a clear-cut determination), (ii) that no taxpayer funds be used to prevent such a receivership and (iii) that funds expended on the termination or transfer of the swaps activities in liquidation would be recovered through the liquidation of the assets of the swaps entity and if necessary by assessment, including on the financial sector.

Under the Lincoln Provision the Council is given the ability, on an institution-by-institution basis, to determine that a swaps entity may no longer access federal assistance when other provisions established by the Act are insufficient to effectively mitigate systemic risk and protect taxpayers. Presumably that authority would be used only in extraordinary circumstances, but that clause poses some uncertainty for institutions relying upon the Lincoln Provision to engage in swaps activities and for their counterparties.

The Lincoln Provision does not become effective until two years following the date on which the Derivatives Title is effective.⁵² Following the effective date, there is a transition period of up to an additional 24 months during which the insured depository institution is to bring its derivatives activities into compliance, and this period may be extended for up to one additional year by the appropriate Federal bank regulator, after consultation with the CFTC and the SEC. The Lincoln Provision also has a grandfathering provision for swaps entered into before the end of the transition period. Although not free of ambiguity, it appears that the grandfathering is intended to survive the ultimate “push out” date for swaps entered into before that date.

While the transition period should reduce some of the worst short-term disruptive effects that could have been caused to banks and their counterparties by a more precipitous effective date, the provision nevertheless could adversely affect the profitability and risk management of the large U.S. financial institutions that have acted as leading derivatives dealers and potentially cause a loss of business by U.S. banking organizations to non-U.S. competitors.

Business Conduct Standards; Special Requirements With Respect to Special Entities⁵³

Under the Derivatives Title, swap dealers and Major Participants generally are subject to comprehensive business conduct standards such as disclosure responsibilities including as to material risks, material incentives and conflict of interests and mark-to-market information.

In addition to these generally applicable standards, the Derivatives Title imposes additional requirements upon swap dealers when acting as an advisor, and to swap dealers and Major Participants when

⁵²It is not entirely clear whether this means the General Effective Date that is extendible by the time required for rulemaking, or if this refers to the hard date that would be two years and 360 days following enactment.

⁵³Act §§ 731 (to be codified at 7 U.S.C. 1 *et seq.*) & 764 (to be codified at 15 U.S.C. 78a *et seq.*).

acting as a non-advisor counterparty, to a “Special Entity.” A “Special Entity” means a federal agency, a state, state agency, city, county, municipality or other political subdivision of a state, an employee benefit or governmental plan as defined in ERISA, and any endowment. When acting as an adviser, the swap dealer will have a duty to act in the best interests of the Special Entity and will be required to make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap recommended by the swap dealer is in the best interests of the Special Entity. When acting as a non-adviser counterparty to a Special Entity that is not an ERISA plan, a swap dealer or Major Participant must determine that the counterparty is advised by an independent representative that meets certain specified criteria. When acting as a non-adviser counterparty to an ERISA plan, a swap dealer or Major Participant must determine that its counterparty is advised by an ERISA fiduciary.

Abusive Swaps and Foreign Entities⁵⁴

The Act provides that the CFTC or SEC may, by rule or order, collect information and issue a report on which types of swaps, if any, the CFTC or SEC determines are detrimental to the financial stability of financial markets or financial market participants. The intended purpose of such a report would presumably be to strictly regulate or ban any type of swap that the CFTC or SEC determines to be detrimental.

The Act also provides that, if the CFTC or SEC determines that the manner of regulation of swaps or swap markets in a foreign country undermines the stability of the U.S. financial system, the CFTC or SEC, in consultation with the Secretary of the Treasury, may prohibit an entity domiciled in the foreign country from participating in any swap activities in the United States.

Rulemaking on Conflicts of Interest⁵⁵

In order to mitigate conflicts of interest, the Derivatives Title requires the CFTC or SEC to determine, within 360 days following enactment, whether to adopt rules to establish limits on the control of any DCO (in the case of the CFTC) or clearing agency (in the case of the SEC) that clears swaps, any swap execution facility or any board of trade designated as a contract market (in the case of the CFTC) or national securities exchange (in the case of the SEC) that posts swaps or makes swaps available for trading, by a bank holding company⁵⁶ with total consolidated assets of \$50 billion or more, a nonbank financial company⁵⁷ supervised by the Federal Reserve Board, any affiliate of such a bank holding company or nonbank financial company, a swap dealer, a Major Participant or an associated person of a swap dealer or Major Participant.⁵⁸ The Act provides that such rules should be adopted if necessary to, among other things, mitigate systemic risk, promote competition or mitigate conflicts of interest in connection with a swap dealer’s or Major Participant’s conduct of business with a DCO or clearing agency (as applicable), a contract market or national securities exchange (as applicable), or swap execution facility in which such swap dealer or Major Participant has a material debt or equity investment. In adopting rules pursuant to this provision, the CFTC or SEC, as applicable, is required to

⁵⁴Act §§ 714 & 715.

⁵⁵Act §§ 726 & 765.

⁵⁶As defined in § 2 of the BHCA.

⁵⁷As defined in the Act.

⁵⁸A person “associated with” a swap dealer or Major Participant is defined to include, among others, any partner, officer, director or branch manager of the swap dealer or Major Participant, or any person occupying a similar status or performing similar functions.

consider any conflicts of interest arising from the amount of equity owned by a single investor; the ability to vote, cause the vote of, or withhold votes entitled to be cast on any matters by the holders of the ownership interest; and the governance arrangements of any DCO or clearing agency.

Preemption of State Regulation⁵⁹

In addition to allocating the jurisdiction of the CFTC and SEC over swaps and security-based swaps, respectively, the Derivatives Title prohibits the regulation of swaps or security-based swaps as insurance contracts under state law.

Extraterritorial Application⁶⁰

The Derivatives Title specifies certain limitations on the potential extraterritorial scope of its provisions. The Derivatives Title specifies that the provisions of the CEA relating to swaps (in this context, excluding security-based swaps) added by the Derivatives Title do not apply to activities outside the U.S. unless those activities “(1) have a direct and significant connection with activities in, or effect on, commerce of the U.S., or (2) contravene such rules or regulations as the CFTC may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision” of the CEA enacted by the Derivatives Title.⁶¹

The Derivatives Title specifies that the provisions of the Exchange Act added by the Derivatives Title do not apply to any person “insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States,” unless that person “transacts such business in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate to prevent the evasion of any provision” of the Exchange Act added by the Derivatives Title.⁶²

The Derivatives Title does not include any express exemptions for non-U.S. entities from the requirements applicable to swap dealers or Major Participants. Many non-U.S. entities will be subject to regulation as swap dealers because they conduct substantial activities of that type in the U.S. However, the extent to which the Derivatives Title would affect their activities outside the U.S. remains to be clarified during the rulemaking process, and presumably will include coordination with relevant foreign regulatory authorities.

The Derivatives Title also leaves open issues with respect to non-U.S. entities that on the basis of their swap positions may be categorized as Major Participants. For example, it is uncertain whether such entities would be excluded by regulation from the Major Participant category if they enter into swaps only outside the U.S. and only with non-U.S. entities. The intended scope of the definition of “Major Participant,” and in particular the extent to which it may apply to entities outside the U.S., may not be known with certainty until the rulemaking process has been concluded (if then). However, past experience with similar language under the Exchange Act, for example, would suggest that having counterparties or customers in the U.S., or using a clearing or trading facility in the U.S., among other activities, could be a sufficient nexus for a foreign person to be subjected to regulation under the Derivatives Title.

⁵⁹Act §§ 722 (to be codified at 7 U.S.C. 2(a)(1)) & 767 (to be codified at 15 U.S.C. 78a *et seq.*).

⁶⁰Act §§ 722 (to be codified at 7 U.S.C. 2(a)(1)) & 772(b) (to be codified at 15 U.S.C. 78dd).

⁶¹Act § 722 (to be codified at 7 U.S.C. 2(a)(1)).

⁶²Act § 772(b) (to be codified at 15 U.S.C. 78dd).

Coordination with foreign regulatory authorities will involve many challenging issues — in addition to the extraterritoriality issues mentioned above, areas where a complementary approach is to be sought include bank capital requirements and the regulation of derivatives. So far, the European Union and England are only at the talking stage in terms of legislation relating to derivatives and other financial reform issues. While they have voiced support in general terms for action on derivatives for some time, little has been done other than the passage of resolutions, and Germany's somewhat quixotic, unilateral ban on short-selling of certain German financial institutions and credit default swaps on euro-zone government bonds.

On June 15, 2010, for example, the European Parliament issued a resolution, entitled "Derivatives Markets: Future Policy Actions," setting forth in general terms its views on regulatory reform for derivatives, and calling for greater standardization, clearing and reporting of all derivative contracts. The UK Financial Services Authority, on the other hand, does not necessarily agree with the move toward mandatory clearing. The FSA and the UK Treasury recently have expressed concern that the clearing-houses could be forced to clear products that they cannot adequately risk manage, which could cause severe losses. Moreover, neither the UK nor the EU is likely to materially restrict the derivatives business that can be done by banks, which has led to the concern by some U.S. financial institutions, and others, that the Act could result in a loss of business by U.S. banks to their European competitors.

Other countries also have begun to assess their regulatory schemes for derivatives. These include Japan, India, China, Hong Kong, Singapore, South Korea and Taiwan. However, to date, these efforts remain largely or entirely at the task force stage.

It appears that, for the time being, the U.S. will be entering the brave new world of regulated OTC derivatives substantially on its own.

Conclusions

Although not all of the consequences can be predicted, it is clear that the Dodd-Frank Act will have a material impact on the derivatives market. It also is clear that the Derivatives Title and related portions of the Act are largely a framework, with many difficult determinations left to the rulemaking process. The full impact of the legislation will be revealed through the rulemaking process and the ongoing implementation of the regulatory oversight and interpretive functions associated with it.

The Derivatives Title requires that the majority of the implementing regulations be in place within 360 days of the passage of the legislation. Within that period, the CFTC and the SEC, as well as the respective "prudential regulators" for the various types of banking organizations⁶³ must coordinate to give content to key concepts that have been left undefined, set thresholds to determine who will be Major Participants, and set margin and capital requirements — not only for a wide range of financial entities, but also for other market participants that currently have no comparable regulatory capital requirements. In sum, those regulators will be charged with implementing an entirely new regulatory regime for the vast variety of financial products that fall under the rubric of OTC derivatives.

The process will be analytically complex and also would appear to involve enormous logistical complexity, given the need for coordination, in a short period of time, among a number of regulators, across a

⁶³The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Farm Credit Administration.

range of regulated entities that potentially includes every type of business enterprise and investment vehicle. These overlapping spheres of jurisdiction also could pose a longer-term challenge to the efficiency and coherence of the regulatory oversight of OTC derivatives.

Moreover, many of the significant players in the OTC derivatives market are global financial institutions and multinational corporations. It seems unlikely that an optimally effective regulatory scheme can be developed without coordination with foreign banking and other relevant regulators. To do so probably would take longer than 360 days, but not to do so could result in conflicting regulations that could cause market anomalies or disruptions, or undesirable competitive advantages.

The Act does not explicitly ban or limit any particular type of derivatives transaction, such as the so-called “naked” credit default swaps that, together with the leveraged products based on them, including synthetic CDOs, have attracted so much adverse commentary in the wake of the financial upheavals of 2007 and 2008.⁶⁴ Although this may be disappointing to some constituencies, prohibiting specific products can be insufficiently flexible (*i.e.*, it may simply engender variants that could require further legislative or regulatory action to address) or have unintended consequences, such as the chilling effect that an over-broad or ambiguous proscription could have on productive business activity. Instead, the Derivatives Title and related provisions of the Act rely on a combination of factors to reduce risk in the OTC derivatives market, including:

- increasing transparency of the market and reducing the potential for counterparty and systemic risk by requiring the clearing and exchange-trading of standardized swaps (and the public reporting of transaction and pricing data with respect to both cleared and uncleared swaps);
- imposing margin requirements for cleared swaps and (other than with respect to end users) uncleared swaps involving a swap dealer or Major Participant;
- increasing capital requirements for swap dealers and imposing capital requirements for the newly regulated category of Major Participants; and
- limiting the derivatives activities of banking organizations to a significant extent.

The Derivatives Title also authorizes the CFTC or SEC, by rule or order, to collect information concerning the market for any swap or security-based swap, as applicable, and to issue a report with respect to any types of such instruments that it determines to be detrimental to the stability of a financial market or to participants in a financial market.⁶⁵ In addition, Title I of the Act would create the new Council as an inter-agency authority charged with (among other things) identifying and responding to

⁶⁴However, a range of provisions under Title IX of the Act — “Investor Protections and Improvements to the Regulation of Securities,” subtitles C (“Improvements to the Regulation of Credit Rating Agencies”) and D (“Improvements to Asset-Backed Securitization”) — as well as Rule 17g-5 under the Exchange Act, intended to bring increased transparency and competition to the process of rating such securities, which became effective on June 2, 2010, could materially affect the manner in which asset-backed securities and other structured finance securities are structured and offered, including by requiring expanded disclosure, ongoing reporting requirements, and risk retention by persons who organize and initiate asset-backed securities issuances. See “Securitization.” In addition, Section 621 adds a new section to the Securities Act that imposes conflict of interest rules in relation to certain securitizations; on its face, this provision would appear to make it much more difficult for banks to structure synthetic CDOs or similar structures.

⁶⁵Act § 714.

risks to the stability of U.S. financial markets; collecting information relating to and monitoring potential systemic risks; identifying gaps in regulation that could pose risks to the financial stability of the U.S.; and making recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit or other problems spreading among bank holding companies, nonbank financial companies and the U.S. financial markets. Many key provisions of the Derivatives Title contain express references to further standards and requirements that may be adopted by regulation. These provisions collectively would appear to provide the authority to prohibit or otherwise further regulate (such as by the imposition of increased capital charges or position limits) particular derivatives products or practices in the future.

While this approach has the benefit of flexibility, and the potential to adapt to new developments or changing conditions, it may carry the risk of uncertainty in the marketplace. In addition, the proposed limitations on the derivatives activities of banking organizations could have unintended negative consequences, such as reducing the profitability of banks, reducing competition in the providing of derivatives products, increasing the costs of derivatives products, and putting U.S. banks at a competitive disadvantage.

Finally, as noted above, it will require significant time, expense and effort for participants in the market to comply with the terms of the derivatives legislation. In addition to the potential adverse impact on bank profits of the Volcker Rule and the Lincoln Provision, which together materially restrict the derivatives business that can be done by U.S. banks, the legislation may adversely affect certain sectors of the structured finance market. The higher capital charges that are expected to apply to the derivatives activities of swap providers presumably will be passed on by swap dealers to their counterparties. Thus, the Act could significantly challenge the ability to consummate structured finance transactions based on credit derivatives and may adversely affect even the more traditional consumer finance or trade receivables securitizations, to the extent it increases the cost of interest rate and currency hedging transactions. While disincentives to synthetic securities transactions probably are intentional, adversely affecting the ability of traditional structures to hedge interest rate and currency risk may be an additional, unintended effect of the new rules and may reduce or increase the costs of credit available to consumers or manufacturing companies.