

DERIVATIVES:

Current Developments Under Dodd-Frank

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Dodd-Frank Title VII: Limitation on Bank Swap Business and Centralized Swap Clearing¹

Enacted July 21, 2010

General Overview

Goals of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”)?

- move the riskiest derivatives and swaps (collectively, “swaps”) off the books of insured depository institutions
- create clearing markets for all swaps
- provide real-time public reporting, including public access to trade data including volume and pricing
- place margin and capital requirements on swap transactions to create stability and require risk management in the market
- allows for netting of swap positions, which will provide better transparency of the overall notional value exposure of swaps in various categories
- the Act does not require public disclosure in real time of the identities of counterparties to swaps, which is a failure to address one of the chief problems during the financial crisis;
 - swap dealers and major swap participants are required to keep daily trading records identifying counterparties, which provides some comfort, but the risk for future overexposure to or of counterparties remains
 - it is likely such daily trading records will be required, by rules to be promulgated by the applicable Commissions (as defined below), to be kept in a format that shows both aggregate positions and net positions and the identities of counterparties

Regulators

See Sections 741 and 764²

- Commissions
 - CFTC regulates swaps that are not security-based swaps (i.e., a swap referencing a specific security)
 - SEC regulates security-based swaps (i.e., a swap referencing an index of multiple securities, or referencing a commodity)

1 **THIS MATERIAL DOES NOT CONSTITUTE A LEGAL OPINION OR ADVICE RELATED TO ANY OF THE SUBJECTS OR TOPICS MENTIONED HEREIN.**

2 All section references herein refer to the applicable section of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Pub. L. No. 111-203 (2010).

- prudential regulators (e.g., Federal Reserve Board, Comptroller of Currency, FDIC, etc.) are responsible for enforcing various provisions of Title VII, particularly the segregation, capital, and margin requirements, as to those entities for whom they are prudential regulators
 - for those entities that do not have a prudential regulator, the applicable Commission (depending on the type of swaps involved) will enforce such provision

Swap

See Section 721

- the term “swap” is broadly defined to include all commonly-known derivative and swap contracts
- certain transactions do not fall within the definition of “swaps”, including repurchase agreements and securities lending transactions;
 - this is contrary to the federal Bankruptcy Code, which includes repurchase agreements within the definition of swaps
 - repurchase agreements and securities lending transactions are treated as creating “credit exposure” (a term yet to be defined) under section 610 of Title VI of the Act, which credit exposure will now be included in calculating legal lending limits
 - repurchase agreements and the lack of transparency regarding them was a major reason for the Bear Stearns and Lehman Brothers failures

Recommendation for Enforcement

See Sections 741 and 764

- if the applicable Commission suspects that a swap dealer or major swap participant has violated a prudential provision, then it may recommend that the prudential regulator commence enforcement actions
- a prudential regulator that suspects that a swap dealer or major swap participant has violated a non-prudential provision may recommend that the applicable Commission commence enforcement action
- if no enforcement has been initiated by the entity with exclusive enforcement authority over the applicable provision within 90 days of receiving an enforcement recommendation, the recommending entity may itself initiate enforcement

The “Push Out” Rule

Prohibition Against Federal Assistance

See Section 716

- any insured depository institutions loses access to Federal assistance (e.g., access to discount window, FDIC insurance and guarantees, etc.) if they offer or trade in certain perceived highly risky swaps, such as equity swaps, certain commodities swaps, energy

swaps, cleared non-investment grade credit default swaps and uncleared investment-grade credit default swaps

- prohibition becomes effective two (2) years after the effective date of the Act
 - transition period of up to 24 months (and may be extended to 36 months) to divest or cease operations with respect to certain products (e.g., equity swaps, certain commodities swaps, energy swaps, cleared non-investment grade credit default swaps, uncleared investment grade credit default swaps, etc.), or
 - transfer such products to affiliates (including their broker-dealer affiliates) subject to capitalization requirements and the requirements under sections 23A and 23B of the Federal Reserve Act³
- however, such insured depository institutions do not lose access to Federal assistance if they limit their swaps activities to certain traditional bank activities, such as:
 - hedging and other similar risk mitigating activities directly related to the insured depository institution's activities
 - acting as a swaps entity with regard to swaps referencing certain interest rates, foreign currencies, gold, silver, precious metals, investment grade debt (but not equity) securities, loans, and promissory notes, etc.
 - acting as a swaps entity for credit default swaps, including swaps referencing the credit risk of asset-backed securities, but only if such swaps are cleared by a clearing organization that is registered or exempt from registration
- the "Push Out" rule roughly parallels the proprietary trading restrictions enacted under section 619 of Title VI of the Act, known more commonly as the Volcker Rule
- the Commissions are granted the discretion to except entities from these rules
- section 716(l) of the Act grants the Financial Services Oversight Council override authority to prohibit any entity from receiving Federal assistance

Clearing Requirements

Clearing

- generally, "clearing" refers to settlement of a transaction
- as to swaps, clearing means that a transaction between counterparties A and B is novated, such that each counterparty no longer faces each other, but instead both face the central clearing organization
 - A's transaction with B becomes A's transaction with C
 - B's transaction with A becomes B's transaction with C

3 Federal Reserve Act sections 23A and 23B will permit a bank to place its business with respect to such products in an affiliate only if such transaction does not exceed 10% of a bank's capital stock and surplus, and all transactions with all affiliates combined do not exceed 20% of the bank's capital stock and surplus. In addition, such transactions must be on terms and conditions that are consistent with safe and sound banking practices, and must be on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with unaffiliated companies.

- the clearing organization becomes the counterparty at risk to the original transaction with both original counterparties
- the clearing organization, as the central counterparty to transactions, nets its positions with all of its members, but would not, make the transactions available to the public
- the central counterparty would charge initial and variation margin to all of its members
 - the initial margin amount would be based upon the portfolios of each counterparty, such that, for instance, counterparty F has a very large and extended portfolio, its initial margin requirements would be higher to reflect that fact

Requirement to Clear Swaps

See Section 723

- the Act makes it unlawful for any person to engage in a swap that is required to be cleared unless the swap is
 - submitted to a registered derivatives clearing organization for non securities-based swaps (e.g., Chicago Board of Trade) or a registered clearing agency for securities-based swaps (e.g. The Depository Trust Clearing Corporation) (each, a “clearing organization”); or
 - the transaction or counterparty is exempted from registration
- a clearing organization must submit each group, category, type or class of swaps to the applicable Commission for a determination of whether clearing is required
 - all swaps listed for clearing by clearing organizations at the time of the Act’s passage are deemed submitted to the applicable Commission for a determination of whether the clearing requirement should apply
- in determining whether a swap requires clearing, the applicable Commission shall
 - provide 30-days for public comment, and
 - make its determination within 90 days after receiving the submission unless the submitting party agrees to a longer period
- in making its determination, the applicable Commission shall consider:
 - existence of significant outstanding notional exposures, trading liquidity and adequate pricing data;
 - ability to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded;
 - whether clearing will mitigate systemic risk, taking into account the size of the market;
 - effect on competition, including clearing fees and charges; and
 - insolvency ramifications
- the Commissions cannot require a clearing organization to list a swap that would threaten such organization’s financial integrity
 - the Commission may take actions to minimize the risks caused by such unlisted swaps (e.g., additional margin or capital requirements)

- the SEC has started the rule making procedures with respect to the ownership and control of clearing organizations, including the avoidance of conflicts of interest, as currently available, at: <http://www.sec.gov/rules/proposed/2010/34-63107.pdf>

Choice of Clearing Organization and to Clear

See Sections 723 and 763

- if a swap that is subject to the clearing requirements is entered into between a swap dealer or a major swap participant and a counterparty that is not a swap dealer or a major swap participant, then such counterparty may choose the clearing organization
- if a swap is not required to be cleared, then the counterparty that is not a swap dealer or a major swap participant may elect to have that swap cleared at a clearing organization of its choice

Promulgation of Submission and Oversight Regulations

See Sections 723 and 763

- no later than one (1) year after enactment of Section 723, each Commission shall adopt rules for clearing organizations' submission of swaps for determination of whether clearing is required
- no later than one (1) year after the date of the enactment of the Act, each Commission shall adopt rules to review a derivative clearing organization's clearing

Commercial End-User Exception

See Sections 723, 731, 763 and 764

- a swap counterparty that is not a financial entity (e.g., industrial companies, energy companies, etc.), may avoid clearing its swaps if it is using the swaps to hedge its commercial risk and provides the applicable Commission with the required notice, which includes information on the ways such counterparty generally meets its financial obligations under its uncleared swaps
- as originally drafted this exception was intended to exempt institutions that pose little risk to the financial markets from having to tie up large amounts of capital or margin with their clearing organization
 - subsequent changes to sections 731 and 764 provided that margin and capital requirements will be applicable to all uncleared swaps entered into, including by commercial end-users (for further reference as to this topic, see the following article: <http://blogs.wsj.com/economics/2010/07/01/dodd-lincoln-try-to-quell-derivatives-fury/>)
 - this seemingly unintended consequence of the Act was addressed in a letter from Senators Dodd and Lincoln to Representatives Barney Frank and Colin Peterson, claiming that the provisions were altered merely to eliminate redundancy, stating, that the Act "does not authorize the regulators to impose margin on end users, those

exempt entities that use swaps to hedge or mitigate commercial risk” (a copy of this letter may be found at:

<http://online.wsj.com/public/resources/documents/dodd-lincoln-letter070110.pdf>)

- the applicability of the margin requirements to energy companies and other large industrial concerns has been a point of contention since the Act was signed into law
 - the dilemma is that, while commercial end users should have been exempted from the capital and margin requirements by virtue of their swaps not being cleared, a provision in sections 731 and 764 requires (by use of the word “shall” rather than “may”) that the Commissions or prudential regulators, as applicable, impose capital and margin requirements on all uncleared swaps, including those used by commercial end users

Enforcement of Clearing Requirement

See Section 729

- the Commission or any other government entity does not have the authority to void a swap entered into in violation of the rules and regulations promulgated under the Act
- counterparties to such a swap do not have the right to void, rescind or recover any payment for a swap based solely on its failure to be cleared or meet the definition of swap
- the Act provides for civil money penalties imposed by the applicable Commission in twice the amount otherwise available on any designated clearing organization, swap dealer, or major swap participant that knowingly or recklessly evades or participates in or facilitates an evasion of the clearing requirements
- the Act provides a court may impose equitable remedies, including restitution to persons who have sustained losses proximately caused by a violation of the Act and the disgorgement of gains in connection with such violation
- the Act provides civil and criminal penalties imposed by the applicable Commission and a private right of action against any person that uses “any manipulative or deceptive device or contrivance” in contravention of the rules promulgated under the Act

Segregation; Bankruptcy

See Section 724

- the Act imposes segregation requirements for cleared and uncleared swaps
- any person that holds assets guarantying swaps cleared by a derivatives clearing organization for other customers must register as a “futures commission merchant”
 - this rule would seem to import into the Commodity Exchange Act a long-accepted principle in the securities world exemplified by Rule 15c-3 under the Securities Exchange Act

- a future commission merchant shall treat all assets held to margin, secure or guarantee a swap (including any assets accruing to the customer as a result of the swap) as belonging to the swap customer
 - this allows for the assets so segregated not to be trapped in an insolvency or bankruptcy proceeding in the event of the future commission merchant's bankruptcy

Reporting

Reporting Requirements

See Sections 727, 731 and 733

- all swaps (whether cleared or uncleared) must be reported to a registered swap data repository, which must then accept, maintain, confirm and make available swap data to the appropriate Commission, the prudential regulators, the Financial Stability Oversight Council, and the Department of Justice
 - there are currently at least three such repositories, though not yet registered: TriOptima (for interest rate derivatives); DTCC Warehouse Trust (for credit derivatives); and DTCC Derivatives Repository Ltd. (for equity derivatives)
- the applicable Commissions are to promulgate rules to require real-time public reporting on all swap transactions, including volume and pricing information, but specifically excluding the identities of the counterparties
 - however, counterparty identities are available upon inspection of the records of the swap dealers and major swap participants, who are required to record such information daily (though such information would not be publicly available)
- the Commission may allow for a delay in reporting on "block trades" (which term is as yet undefined)
- counterparty to an uncleared swap that is not the entity that submitted the report must:
 - provide swap data reports to the applicable Commission upon written request, and
 - maintain relevant books and records which must remain open to inspection
- the Commissions will prescribe rules regarding the timely publication of trading information (e.g., price, trading volume and other miscellaneous data) on swaps

Large Swap Transaction Reporting

See Section 730

- if a swap performs a "significant price discovery function"⁴ and one counterparty meets or exceeds the daily limit of such swap set by the applicable Commission, then the counterparty

4 In making a determination whether a swap performs or affects a "significant price discovery function" with respect to regulated markets, the Commission shall consider, as appropriate:
 (A) PRICE LINKAGE.—The extent to which the swap uses or otherwise relies on a daily or final settlement price, or other major price parameter, of another contract traded on a regulated market based upon the same underlying commodity, to value a position, transfer or convert a position, financially settle a position, or close out a position.

must file reports with the Commission detailing the transactions and maintain required books and records

- it is unclear as to how this reporting requirement would differ from the general reporting requirements under the Act
- possibly, the Commissions could require more extensive disclosures
- the size of transactions that will be subject to Section 730 is another part of the Act that will be determined in the rule promulgation procedure

Registration and Record Keeping

See Section 731

- all swap dealers and major swap participants must register with the applicable Commission in writing in a form and manner prescribed by such Commission
 - registration requirements will commence within one (1) year of the date of enactment of the Act
- an officer of each swap dealer and major swap participant must submit annual reports that describe the actions the entity is taking to comply with the rules and regulations promulgated by the applicable Commission
 - such report must also include certain information regarding the swaps that it entered into during the prior year

Transition Reporting

See Sections 723, 763 and 766

- swaps entered into prior to the date of enactment must be reported to a registered swap data repository, or the applicable Commission, no later than 180 days after the effective date of the Act (and are exempt from the clearing requirements upon being so reported)
- swaps entered into after the date of enactment of the Act must be reported to the swap data repository or the applicable Commission within 90 days effective date of the Act or such other period as the Commission may determine (and are exempt from the clearing requirement upon being so reported)
- the SEC has adopted a new interim final rule to require a counterparty to an unexpired security-based swap entered into prior to enactment of the Act to submit a copy of the

(B) ARBITRAGE.—The extent to which the price for the swap is sufficiently related to the price of another contract traded on a regulated market based upon the same underlying commodity so as to permit market participants to effectively arbitrage between the markets by simultaneously maintaining positions or executing trades in the swaps on a frequent and recurring basis.

(C) MATERIAL PRICE REFERENCE.—The extent to which, on a frequent and recurring basis, bids, offers, or transactions in a contract traded on a regulated market are directly based on, or are determined by referencing, the price generated by the swap.

(D) MATERIAL LIQUIDITY.—The extent to which the volume of swaps being traded in the commodity is sufficient to have a material effect on another contract traded on a regulated market.

(E) OTHER MATERIAL FACTORS.—Such other material factors as the Commission specifies by rule or regulation as relevant to determine whether a swap serves a significant price discovery function with respect to a regulated market.

transaction confirmation and the time the transaction was executed to a swap data repository or to the SEC within 60 days of a swap data repository for security-based swaps becoming operational, or, if earlier, the date to be established by SEC rules

- parties to unexpired security-based swaps entered into prior to enactment of the Act must retain all information and documentation that exists relating to such transaction's terms

See Interim Final Temporary Exchange Act Rule 13Aa-2T

Capital and Margin Requirements and Position Limits

Capital and Margin Requirement for Swap Dealers and Major Swap Participants

See Sections 731 and 736

- margin requirements must be imposed on swap dealers and major swap participants
 - for non securities-based swaps, the CFTC sets forth the margin levels that various self-regulating entities (e.g., futures commission merchants, etc.) must require
 - such CFTC margin requirements
 - must be limited to protecting the financial integrity of swaps;
 - must be designed for risk management purposes to protect the financial integrity of transactions; and
 - cannot set "specific margin amounts" (as opposed to specific percentages?)
 - as to securities-based swaps, under existing law margin requirements are already similarly filtered down (though originating from the Federal Reserve Board rather than the SEC) through various self-regulating entities (e.g., broker dealers, etc.)
- the Act requires clearing organizations to establish internal margin requirements to minimize market risk prior to clearing a swap
 - an agency handling the cleared swaps of swap dealers and major swap participants that are depository institutions shall impose capital and margin requirements that are greater than zero
 - for non-cleared swaps of these dealers and participants, the applicable Commission shall impose requirements that are "appropriate for the risk associated with the non-cleared swaps"
- if the applicable Commission determines that a swap is required to be cleared, but no clearing organization will list the swap then such Commission may take actions deemed necessary to minimize risks to the market such as requiring additional capital or margin requirements
- the Act requires the prudential regulators, the CFTC and the SEC "to the maximum extent practicable, establish and maintain comparable minimum capital requirements and minimum initial and variation margin requirements" for swap dealers and major swap participants
- the capital and margin requirements for CFTC- and SEC-regulated entities will be promulgated by the applicable Commission, rather than Federal banking agencies

- as discussed above, industrial concerns (i.e., commercial end users of swaps) may be subject to the margin requirements as a consequence of the Act

Position Limits

See Sections 733, 737 and 763

- the relevant Commission shall place position limits on swaps of particular persons, including any group or class of traders, that perform a “significant price discovery function”⁵ with respect to a registered entity, unless the contracts are “bona fide hedge transactions” (this term is undefined by the Act)
 - the forthcoming rules from the CFTC must be established within 180 days from the date of enactment for exempt commodities and within 270 days from the date of enactment for agricultural commodities
- the Commissions may exempt, conditionally or unconditionally, any person or class of persons, any swap or any transaction from the positions limitations
- SEC authorized to establish position limits on any security-based swap and related securities, and to direct self-regulating organizations to adopt similar position limit rules and rules requiring aggregation of positions
- swap execution facilities must set their position limitations at a level no higher than the Commission’s limitations for contracts subject to a Commission’s position limitations

Swap Execution Facilities

Rules Governing Swap Execution Facilities

See Section 733

- swap execution facilities must register with the applicable Commission and the rules and regulations are to be promulgated by the applicable Commission
- none have been registered yet
- swap execution facilities may
 - make any swap available for trading, and
 - facilitate trade processing of any swap, but
 - shall only trade swaps not readily susceptible to market manipulation
- swap execution facilities must be operated in accordance with the Act’s core principles:
 - compliance with the Commission’s rules,
 - prevention of market manipulation, and
 - promotion of trade and pre-trade price transparency
- swap execution facilities must
 - enforce trading rules that:
 - deter abuse, and
 - provide participants with impartial access to the market,

5 See footnote 4 supra.

- establish the infrastructure to identify when and if rule violations have occurred
- information gathered by a Facility must be available to the Commission for its review upon request

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