Title VII: Derivatives
(Wall Street Transparency and Accountability Act of 2010)

Summary:

- Regulates the previously unregulated, over-the-counter (OTC) derivatives market
- Requires registration of swap dealers, major swap participants, swap data repositories and swap execution facilities
- Mandates central clearing and trading of swaps
- Establishes margin and capital requirements for swaps
- Mandates reporting, recordkeeping and business conduct standards
- Mandates position limits, public reporting and large trader reporting
- Prohibits federal assistance for regulated swap dealers and traders, which may require some financial institutions to restructure their derivatives-dealing activities to "push-out" certain OTC derivatives-trading activity to separately capitalized, affiliated companies

For ease of reference, unless otherwise noted, this summary uses the term "swap" to mean both swaps and security-based swaps (and, by extension, "swap dealer" also means a security-based swap dealer, and "major swap participant" means a major security-based swap participant). Similarly, "regulator" means the CFTC with respect to swaps, and the SEC with respect to security-based swaps (abbreviated in paragraph headings as "sbs").

Effective Date (sections 754 for swaps; 774 for sbs)

Unless otherwise noted below, these provisions take effect on the later of 360 days after the date of enactment (July 15, 2011, as President Obama signed Dodd-Frank Act on July 21, 2010) or, to the extent a rulemaking is required for a specific provision, then it will become effective no less than 60 days after publication of the applicable final rule or regulation.

Regulation of Swaps (sections 721 for swaps; 761 for sbs)

The regulatory architecture of Title VII rests upon the regulation of "swaps" and "security-based swaps," two new terms defined by the legislation in an extremely broad manner. In common-market parlance, a "swap" is any OTC forward, swap or option on an underlying or reference instrument that is not an individual security or loan, or an index with less than 10 component securities or loans (a "narrow-based security index). In other words, OTC currency, qualifying index-based credit, commodity and interest rate derivatives are the primary categories of swaps. Conversely, a "security-based swap" is any OTC contract with a reference instrument that is an individual security or loan, or a narrow-based security index. The primary categories of security-based swaps are OTC equity and credit derivatives that reference a *single* security or loan or any OTC derivative that references a narrow-based security index.

Title VII contains a few notable exclusions and exceptions from this broad definition. First, the Treasury Secretary has the authority to exempt foreign exchange (FX) forwards and FX swaps from the regulatory requirements of Title VII (other than reporting and business conduct requirements). This discretionary authority does not apply to OTC FX options—in other words, OTC currency options will be subject to the full regulatory regime of Title VII. Second, exchange-traded futures and options, retail FX contracts, and any security-based swaps are all excluded from the definition of a swap. Third, a transaction is not a swap if it involves the sale of a non-financial commodity on a delayed

delivery basis, and the parties intended to physically settle the contract at they time they entered into the trade. This exclusion is expected to be interpreted in a manner consistent with the existing forward contract exclusion in the U.S. Commodities Exchange Act.

As a general matter, the CFTC has jurisdiction over activity that involves swaps, while the SEC has jurisdiction over security-based swap activity; the regulators share jurisdiction over activity in connection with a transaction that shares characteristics of both a swap and a security-based swap (a "mixed-swap").

Registration and Regulation of New Market Participants (sections 721 for swaps; 761 for sbs)

Title VII creates an entirely new regulated industry that will involve the registration and regulation of entirely new classes of market participants: regulated traders (defined in Title VII as "swap dealers" and "major swap participants"), and regulated facilities (defined as "swap data repositories" and "swap execution facilities").

A "swap dealer" is any person that: (1) holds itself out as a dealer in swaps; (2) makes a market in swaps; (3) regularly enters into swaps for its own account as an ordinary course of business; or (4) engages in activity that causes the person to be commonly known in the trade as a swaps dealer. There are two notable exemptions. First, an insured depository institution will not be a "swap dealer" if it offers to enter into a swap with a customer in connection with originating a loan to a customer. Second, "de minimis" activity (to be defined by regulators) in swap dealing will not subject an entity to registration and regulation as a swap dealer.

A "major swap participant" is a non-dealer: (1) that maintains a substantial position in any major category of swap (to be defined by regulators), excluding swaps held for hedging or risk mitigation purposes, or maintained by an ERISA plan for hedging or mitigating risks directly associated with the operation of a plan; (2) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (3) that is a highly leveraged financial entity (that is not subject to federal banking regulation) that maintains a substantial position (to be defined by regulators) in outstanding swaps in any major swap category. For purposes of this definition, Title VII does not define the term "financial entity," so this term will need to be defined through the regulatory process. The definition of a major security-based swap participant is substantially similar to the definition of a swap dealer with one exception – the definition of a major swap participant expressly excludes a captive finance subsidiary; while the definition of a major security-based swap participant does not.

A "swap execution facility" is a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system. The definition includes any trading facility that facilitates the execution of swaps between persons and is not a futures or stock exchange.

A "swap data repository" is any person that collects and maintains information with respect to swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility for the swaps.

Mandatory Clearing and Trading Requirements (sections 723 for swaps; 763(a) for sbs)

A regulator can mandate the central clearing of a swap or approve a particular swap for central clearing upon the petition of a clearing firm. In the case of a swap, a "derivatives clearing organization" will act as the clearing firm, while security-based swaps will clear through a "clearing agency." The factors to be considered by the regulator in mandating or approving the clearing of a particular swap include the outstanding notional exposure, trading liquidity, pricing data, effect on systemic risk, competition, and insolvency treatment of the swap. All centrally cleared swaps must be executed through an exchange or a swap execution facility (SEF), to the extent that there is an exchange or SEF that will trade the swap.

There is a so-called "end-user exemption" from the mandatory clearing requirement, if one of the parties is ***not*** a financial entity and ***is*** using the swap to hedge or mitigate commercial risk. A "financial entity" consists of any of the following: a swap dealer, a major swap participant, an ERISA plan, a commodity pool, a private investment fund (*i.e.*, a 3(c)(1) or 3(c)(7) fund), or a financial institution. A party can act as an agent of an affiliated party or an affiliate of that affiliated party and utilize the end-user hedge exemption, so long as neither the principal (nor, if applicable, its affiliate)

is a financial entity. To avail itself of the end-user exemption, a party must notify the regulator how it "generally meets its financial obligations in respect of non-cleared swaps."

Capital and Margin Requirements for Cleared Swaps (sections 725 for swaps; 763(b) for sbs)

Title VII will also result in the imposition of capital requirements on dealers and participants, as well as margin requirements in respect of cleared swaps and cleared security-based swaps – although, regulatory structural differences between the CFTC and the SEC may affect the exact manner in which these mandates are implemented. Interestingly, the margin required by a DCO from each member and participant in respect of cleared swaps "shall be sufficient to cover potential exposures in normal market conditions." Title VII does not articulate a parallel standard for security-based swaps, although there is a general requirement for consistency in regulation of swaps and security-based swaps.

Capital and Margin Requirements for Non-Cleared Swaps (sections 731 for swaps; 764(a) for sbs)

Title VII establishes capital and margin requirements for non-cleared swaps. Each registered dealer or participant subject to the supervision of a prudential regulator (e.g., a bank) must meet the prudential regulator's requirements in respect of minimum capital initial and variation margin for non-cleared swaps. All non-bank registered dealers or participants must meet the minimum capital and margin requirements established by the CFTC or the SEC, as applicable, for non-cleared trades. To offset the greater risk posed to the dealer/participant and the financial system as a whole by non-cleared swaps, the capital and margin requirements must be established in a way that ensures the safety and soundness of the dealer/participant and is appropriate for the risks associated with such non-cleared swaps. Margin in the form of non-cash collateral is acceptable, provided that such collateral is consistent with the broader goal of preserving the financial integrity of markets and the stability of the U.S. financial system. The prudential regulators, the CFTC and the SEC are required, to the maximum extent practicable, to maintain comparable minimum capital requirements and minimum initial and variation margin requirements, including the use of non-cash collateral, for dealers or participants. The exact levels of margin and capital for non-cleared swaps will be established through the rulemaking process and are not known at this time.

Segregation of Margin (sections 724 for swaps; 763(d) for sbs)

Title VII only permits a registered futures commission merchant or broker dealer to hold customer property as margin in respect of swaps or security-based swaps, respectively. Any such margin must be segregated from the property of the FCM/broker. Furthermore, in the case of a non-cleared swap, the customer can request that an independent third-party custodian maintain custody of the margin. We expect that these requirements will affect liquidity in the financial markets, since dealers will no longer be able to freely use or re-pledge collateral that they receive from counterparties in respect of swap trades.

Reporting, Recordkeeping and Business Conduct Standards (sections 731 for swaps; 764(a) for sbs)

Each swap dealer or major swap participant shall: (i) submit reports required by CFTC or SEC, as applicable, regarding transactions and positions and financial condition, and shall keep books and records as prescribed by the CFTC or SEC, as applicable, (ii) maintain daily trading records of each swap, recorded communications, and daily trading records for each trading counterparty, (iii) comply with business conduct standards related to (a) fraud, manipulation and abuse, (b) diligent supervision of their business, (c) adherence to position limits, and (d) other matters the CFTC or SEC determine to be appropriate. Each swap dealer or major swap participant is required by business conduct standards to: (i) verify that the counterparty meets eligibility standards for eligible contract participant, (ii) disclose material risks and characteristics of swaps, (iii) disclose for any cleared swap, if requested, the daily mark of that transaction from the derivatives clearing organization, (iv) disclose for any uncleared swap the daily mark of that transaction, (v) communicate in a fair and balanced manner based on principles of fair dealing and good faith, and (vi) comply with other standards imposed by the CFTC or SEC determined to be appropriate in the public interest, for the protection of investors, or otherwise in furtherance of Title VII.

Greater responsibilities apply to advice given to, or transactions entered into with, any "special entity" (defined as a federal agency, state agency, employee benefit plan, governmental plan under ERISA, or any endowment under 501(c)(3) of Internal Revenue Code). Each swap dealer, security-based swap dealer, major swap participant or major security-based swap participant shall designate a chief compliance officer.

Mandates Position Limits (sections 737 for swaps; 763(h) for sbs), Public Reporting (sections 727 for swaps; 763(i) and 766 for sbs), and Large Swap Trader Reporting (sections 730 for swaps; 763(h) for sbs)

Position Limits: The CFTC is authorized establish limits on the amount of positions, “other than bona fide hedge positions,” that may be held by any person in respect of swaps and futures contracts. Any such limits should be implemented by the CFTC order to (i) diminish or eliminate excessive speculation, (ii) deter and prevent market manipulation, (iii) ensure sufficient liquidity for bona fide hedgers, and (iv) ensure price discovery function is not disrupted. The SEC is also given authority to establish limits (including related hedge exemption provisions) in respect of security-based swaps, as a means designed to prevent fraud and manipulation.

Public Reporting: The CFTC or SEC, as applicable, are authorized to require (i) registered clearing agencies and swap data repositories to make available to the public in real time, swap transaction, volume and pricing data that does not identify the participants, and that specifies criteria for determining block trades and the timing for disclosure of block trades, (ii) parties to a swap (whether cleared or uncleared) to be responsible for reporting swap transactions and pricing information to a registered swap data repository, and (iii) annual and semiannual public reports by the CFTC or SEC of aggregate swap data.

Large Swap Trader Reporting: It is generally unlawful for any person to enter into any swap that performs a significant price discovery function in excess of a position limit set by CFTC, unless such person files the requisite reports with the CFTC, and keeps books and records of such swaps open to the CFTC. The SEC is also authorized to implement a large trader reporting program in respect of aggregate positions in security-based swaps and underlying securities or loans.

Prohibition on Federal Assistance to Swap Entity (section 716)

This is the so-called "swap push out" provision, which prohibits a "swaps entity" from receiving any “Federal assistance.” A swaps entity means a swap dealer, security-based swap dealer, major swap participant or major security-based swap participant registered as such with the CFTC or SEC, respectively; however, the term excludes an insured depository institution that is a major swap participant or major security-based swap participant. In other words, an insured depository institution will only be treated as a "swaps entity" if it is a swap dealer. “Federal assistance” means the use of any 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), Federal Deposit Insurance Corporation insurance, or guarantees for the purpose of providing support to the swaps entity (regardless of form of support - equity investment, loan, purchase of entity's assets, guarantee, etc.).

As it relates to insured depository institutions, section 716 allows an institution to receive federal assistance, if it limits its trading activities to swaps that (i) are used for hedging or similar risk mitigation activity, or (ii) involve interest rates, currencies, gold, silver and investment grade corporate debt, as well as centrally cleared credit default swaps. Furthermore, if the institution is part of a Federal Reserve supervised bank or savings and loan holding company, then the institution can create a separate affiliate to carry out all other swap activity—including swaps that involve physical commodities, equities and non-investment grade corporate debt—so long as that affiliate operates in compliance with 23A and 23B of the Federal Reserve Act (which, as modified by Dodd-Frank, subjects derivatives to quantitative limits and collateral requirements and, more generally, places restrictions on an institution’s ability to make loans to or investments in any affiliated company). Section 716 also affirms that proprietary trading by an insured depository institution is subject to the limitations of the Volcker Rule.

Section 716 will become effective two years after the effective date of Title VII (*e.g.*, July 15, 2013, based upon the enactment of Dodd-Frank July 21, 2010). An insured depository institution will have an additional two years after section 716 becomes effective (*e.g.*, July 15, 2015) to implement the swap push-out aspects of the provision, subject to rolling one-year extensions to be made by the relevant regulator.

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