The Dodd-Frank Act Mandates Comprehensive Regulation of Derivatives

by Michael Ouimette, Deborah A. Carrillo, and Benjamin R. Uy, Jr.

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act imposes a new derivatives regulation regime that will have a significant effect on a wide range of market participants.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which was signed into law by President Obama on July 21, 2010, imposes a comprehensive and far-reaching regulatory regime on derivatives and market participants. The most significant provisions of the derivative regulation include: (1) mandatory clearing of certain derivative instruments through regulated clearing organizations and mandatory trading of certain derivative instruments on regulated exchanges or swap execution facilities; (2) regulation of derivatives market participants; and (3) divestment or "push out" of many banks' swap activities. As with other portions of the act, the full impact of these provisions will not be known until the regulators promulgate rules. Below are summary answers to questions regarding the Dodd-Frank Act's new derivatives regulatory regime.

Jurisdiction and Definitions: Swaps and Security-based Swaps

Who are the regulating entities?

The Dodd-Frank Act splits regulation of the derivatives markets between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). Generally, the Dodd-Frank Act grants the CFTC jurisdiction over swaps and swap market participants and the SEC jurisdiction over security-based swaps and security-based swap market participants. However, federal bank regulators have enforcement authority with respect to swap dealers and major swap participants that they regulate.

What is a swap?

The Dodd-Frank Act broadly defines a swap to include a wide range of derivative instruments, including interest rate, equity, currency and fixed income derivative instruments. The Dodd-Frank Act defines foreign exchange swaps and forwards as swaps subject to regulation, unless the Secretary of the Treasury determines to exclude such transactions from the swap definition. The definition of a swap excludes most security-based swaps.

What is a security-based swap?

A "security-based swap" is defined as a swap based on (1) a narrow-based security index, (2) a single security or loan or (3) the occurrence, nonoccurrence or extent of occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, if the event directly affects the financial statements, financial condition or financial obligations of the issuer.

What regulating activities does the Dodd-Frank Act prohibit states from engaging in?

States may no longer regulate swaps or security-based swaps as insurance. Also, state gaming and bucket shop laws may no longer effect security-based swaps between eligible contract participants.

Regulation of Swap Dealers and Major Swap Participants

With regard to derivatives, the Dodd-Frank Act regulates two different types of entities: "swap dealers" and "major swap participants."

What is a "swap dealer"?

The term swap dealer is defined as any person who is a dealer or market maker in swaps or who regularly enters into swaps with counterparties in the ordinary course of business for its own account. The term excludes persons who enter into swaps for their own account, either individually or in a fiduciary capacity, but not as part of a regular business. The definition of swap dealer also does not include an insured depository institution to the extent that it offers to enter into a swap with a customer in connection with originating a loan with that customer.

What is a "major swap participant"?

The definition of major swap participant is intended to cover significant non-dealer market participants, and the Dodd-Frank Act groups such participants in three general categories:

- Any non-dealer that maintains a "substantial position" in swaps for any major swap category, excluding positions held for "hedging or mitigating commercial risk" and positions maintained by any employee benefit plan for the primary purpose of hedging risk directly associated with the operation of the plan, will be regulated as a major swap participant.
- Any non-dealer 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" will similarly be regulated as a major swap participant.
- Any non-swap dealer that is a financial entity that is "highly leveraged relative to the amount of capital it holds" and maintains a "substantial position" in swaps will also be regulated as a major swap participant, unless the financial entity is "subject to capital requirements" established by a federal banking regulator.

It should also be noted that the Dodd-Frank Act leaves key aspects of this definition, including the definition of "substantial position", to CFTC/SEC rulemaking and interpretation. The regulating agencies are required to take into account a person's systemic significance when determining whether it holds a "substantial position" in swaps. Moreover, the regulating agencies are also directed to consider the person's relative position in cleared (versus non-cleared) swaps and may consider the value and quality of collateral held against counterparty exposures. It should also be noted that the second and third categories do not provide any exclusion for hedging activity.

Are there registration requirements for swap dealers and major swap participants?

Yes, the Dodd-Frank Act mandates that swap dealers and major swap participants register with the CFTC and/or SEC, as applicable. Notably, the Dodd-Frank Act does not provide registration exceptions for foreign banks or other entities subject to similar regulation.

It should also be noted that a swap dealer or major swap participant is required to register with the CFTC regardless of whether it is also a depository institution or is already registered with the SEC as a security-based swap dealer or major security-based swap participant. Similarly, a swap dealer or major swap participant is also required to register with the SEC regardless of whether it is a depository institution or is already registered with the CFTC as a swap dealer or major swap participant.

Are there capital and margin requirements for swap dealers and major swap participants?

Yes, the Dodd-Frank Act requires regulators to set minimum capital requirements and minimum initial and variation margin requirements for swap dealers and major swap participants. The relevant regulator may take into account the risk associated with non-cleared swaps to "help ensure the safety and soundness" of the swap dealer or major swap participant.

Which agency is responsible for setting these capital and margin requirements?

Generally, federal banking regulators will set capital and margin requirements for swap dealers and major swap participants that are banks. The CFTC or SEC, as applicable, will prescribe the requirements for non-bank swap dealers and major swap participants.

What business conduct standards apply to swap dealers and major swap participants?

Swap dealers and major swap participants must disclose to counterparties that are not swap dealers or major swap participants material risks and characteristics of swaps and any material incentives or conflicts of interest that the swap dealer or major swap participant may have in connection with the swaps. Additionally, the Dodd-Frank Act imposes a duty on swap dealers and major swap participants to verify that any counterparty meets eligibility standards for an eligible contract participant.

What are "special entity" requirements?

Under the Dodd-Frank Act, swap dealers and major swap participants advising a "special entity" in connection with a swap will have a duty to act in the "best interests" of the "special entity." A special entity is defined as a federal, state, or municipal agency, an employment benefit plan or an endowment. A swap dealer or major swap participant acting merely as a counterparty to a special entity in connection with a swap transaction will be required to have a reasonable basis to believe that the special entity counterparty has a qualified representative independent of the swap dealer or major swap participant that undertakes a duty to act in the "best interests" of the special entity counterparty and complies with a number of other additional specified requirements. These obligations do not apply to a transaction initiated by a special entity on an exchange where the swap dealer or major swap participant does not know the identity of the special entity counterparty.

New Mandatory Clearing and Exchange Requirements

What derivatives must be cleared?

The Dodd-Frank Act requires clearing of swaps accepted by a clearing organization that the CFTC, in the case of a swap, or the SEC, in the case of a security-based swap, determines must be cleared. The Dodd-Frank Act mandates that the CFTC and the SEC regularly review swaps to determine if they should be subject to clearing. The CFTC and SEC must also provide a public comment period prior to making such determinations. If the CFTC and SEC determine a swap must be cleared but a clearing organization does not accept such contract for clearing, the Dodd-Frank Act directs and authorizes the regulators to take specific actions.

Must clearing organizations accept all swaps?

The Dodd-Frank Act requires that the rules of the clearing organization provide for non-discriminatory access; but, the Dodd-Frank Act prohibits the CFTC from compelling a clearing organization from accepting the counterparty credit risk of another clearing organization.

What is the commercial end user exemption to clearing?

The Dodd-Frank Act exempts from mandatory clearing any swap counterparty that (1) is not a financial entity, (2) is using the swaps to hedge or mitigate commercial risk *and* (3) notifies the CFTC or SEC how it generally meets its financial obligation associated with entering into non-cleared swaps.

Are commercial end users subject to margin requirements?

Commercial end users are not explicitly exempted from the margin requirements of the Dodd-Frank Act. The legislative history suggests that this was a drafting oversight and commercial end users were not intended to be subject to margin requirements.

What transactions must be traded on an exchange?

Derivative transactions that are subject to mandatory clearing must be traded on a designated contract market or securities exchange or through a swap execution facility, unless no such entity makes the swap available for trade. If the clearing requirement does not apply, then trades may be executed other than on an exchange or through a swap execution facility.

The "Push-Out" Rule (The Lincoln Amendment)

What is the "Push-Out" Rule?

This provision prohibits any "swap entity" from accessing "Federal assistance" (such as FDIC insurance or access to the Fed's discount window) with respect to any swap or swap activity.

What swap dealers are subject to the Push-Out Rule?

Subject to important exceptions, swap dealers and major swap participants registered under the provisions of the Dodd-Frank Act are subject to the Push-Out Rule. However, the Dodd-Frank Act excludes from the Push-Out Rule insured depository institutions acting as swap dealers that limit their swap activities to (1) hedging and other similar risk mitigation activities directly related to their activities and (2) engaging in swaps involving rates or reference assets that are permissible for investment by national banks.

In addition, insured depository institutions that act as major swap participants are excluded from application of the Push-Out Rule. Also excluded are insured depository institutions and "covered financial companies" under Title II of the Dodd-Frank Act that are in conservatorship, receivership or resolution proceedings.

How long do swap entities have to carve out their derivatives activities?

The transition period for the Push-Out Rule will begin two years after the derivatives title of the Dodd-Frank Act becomes effective. The transition period will last for up to two years with the possibility for a discretionary one-year extension. Thus, swap entities that have access to and desire to maintain access to federal assistance may have up to five years to divest or cease their swap activities.

Reporting Requirements and Recordkeeping

The Dodd-Frank Act requires market participants to publicly report all swaps, including those outstanding on the date the act is passed, regardless of whether or not the swap has been cleared (or required to be cleared). All swaps must also be reported to a registered swap data repository or the CFTC or SEC, as applicable. Swap dealers and major swap participants will be obligated to issue reports to the CFTC and/or the SEC, as applicable, regarding their swap transactions and positions and their financial condition pursuant to rules and regulations to be issued by the CFTC and/or the SEC. Swap dealers and major swap participants will also be required to keep books and records relating to their swap activities open for inspection by the CFTC and/or the SEC.

- The CFTC and the SEC must each promulgate an "interim final rule" by August 20, 2010 as to how uncleared pre-enactment swaps are to be reported. Uncleared swaps entered into before July 21, 2010 but that have not yet expired as of such date shall be reported to a swap data repository or regulatory authority not later than 30 days after the issuance of the interim final rule unless the agencies specify otherwise.
- The deadline for reporting swaps entered into on or after July 21, 2010 is the later of (1) 90 days after the effective date of the clearing and reporting requirements and (2) such other time the appropriate regulatory authority may provide.

Impact of the Dodd-Frank Act on Other Securities Laws

What effect does the Dodd-Frank Act have on the Exchange Act and the Securities Act?

The Dodd-Frank Act broadens the definition of "security" under both the Securities Exchange Act of 1934 (Exchange Act) and the Securities Act of 1933 by including security-based swaps in the definition. This means that market participants and regulators alike will have to consider which references to "securities" in federal and state statutes and regulations, investment guidelines and other materials may now incorrectly encompass such swaps.

Can the ownership of security-based swaps affect beneficial ownership status of a security?

Yes, the Dodd-Frank Act amends Section 13 of the Exchange Act by providing that security-based swap positions can give rise to beneficial ownership status of a security for reporting and short-swing profit purposes to the extent that such swaps provide "incidents of ownership comparable to direct ownership of the equity security."

Extraterritoriality Issues

The Dodd-Frank Act excludes from regulation swap activities outside of the United States, unless those activities have a "direct and significant connection" with activities in, or effect on, commerce of the United States. While the scope of this exclusion is ambiguous, it is probable that the requirements of the act will apply to foreign entities dealing with U.S. market participants or executing or clearing swap transactions through a U.S. facility. The CFTC and SEC may, in consultation with the Secretary of the Treasury, prohibit an entity domiciled in a foreign country from participating in swap activities in the United States if such swap activity in the foreign country undermines the stability of the U.S. financial system.

The Dodd-Frank Act instructs the U.S. financial regulators to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards on swaps. The SEC and CFTC may also enter into any information sharing arrangements with foreign regulators they deem necessary or appropriate, in the public interest or for the protection of investors and swap counterparties.

Rulemaking and Effectiveness

When does the Dodd-Frank Act require the CFTC and SEC to promulgate regulations?

Unless specified otherwise, the Dodd-Frank Act requires the CFTC and SEC to promulgate required rules by July 16, 2011.

When do the derivatives provisions become effective?

Generally, the derivatives provisions become effective on July 16, 2011. However, if a provision requires rulemaking, the provision is effective the later of July 16, 2011 or no less than 60 days after publication of a final rule or regulation implementing such provision. In some instances, such as the reporting provision for uncleared swaps and security-based swaps and the position limits provision, the foregoing effective dates do not apply.

If you have any questions about the content of this client alert, please contact the Pillsbury attorney with whom you regularly work or the authors below.

Michael Ouimette (bio)
San Francisco
+1.415.983.1163
michael.ouimette@pillsburylaw.com

Deborah A. Carrillo (bio)
San Francisco
+1.415.983.1801
deborah.carrillo@pillsburylaw.com

Benjamin R. Uy, Jr. (bio)
San Francisco
+1.415.983.1804
benjamin.uy@pillsburylaw.com