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THE DERIVATIVES LEGISLATION: IS THE WORLD NOW SAFER?

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THE DERIVATIVES LEGISLATION: IS THE WORLD NOW SAFER?

One portion of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") that has received a great deal of attention is the section addressing swaps (Title VII of the Act). Although swaps were not the root cause of the recent financial meltdown, as a newer financial product not widely understood outside of the financial marketplace, swaps have become a good target for those of various political stripes. These products have been touted as too "risky" (which has now become a bad word in Washington) and therefore evil or at least inappropriate for U.S. banks and other financial institutions. Unfortunately, the political and populist anger over the financial crisis that has been directed at the derivatives area, together with an unwillingness to challenge the traditional roles of various government agencies, has resulted in sweeping, complicated new legislation affecting swaps that is itself a "risky scheme" (with apologies to Al Gore).

The enormity of the proposed changes, together with the excessive uncertainty resulting from the complexities and ambiguities found throughout the Act, as well as the regulatory structure it creates, could result in both short-term pain for users of swaps and participants in the derivatives markets generally and long-term unintended and undesirable changes in the marketplace. The word "reform" plays a prominent role in the title of the Act. "Reform" means to correct, rectify, or make better. Whether the Act actually accomplishes this remains to be seen.

THE BIG PICTURE

Abandoning the previous regulatory structure, which allowed "eligible contract participants" (a defined term designed to describe parties large enough to be financially sophisticated) to transact in swaps on a bilateral basis with little oversight or regulation, the new bifurcated jurisdictional framework submits virtually all swaps to regulation by either the Securities and Exchange Commission ("SEC") or the Commodity Futures Trading Commission ("CFTC"). The SEC regulates those transactions defined as "security-based swaps" and entities engaging in or related to such security-based swaps, and the CFTC regulates transactions defined as "swaps" and entities engaging in or related to such transactions. Both agencies share joint jurisdiction over "mixed swaps."[1] The Act requires mandatory clearing and trading on or through designated contract markets, national securities exchanges, or swap execution facilities for most swaps, with certain limited exemptions, and imposes significant new regulations and requirements on entities engaging in swap transactions.

- **"Re-regulation."** Most derivatives, including many that were deregulated by the Commodity Futures Modernization Act of 2000, will now be regulated by the CFTC or, in the case of security-based swaps, by the SEC. "Mixed swaps" will be jointly regulated by the CFTC and SEC.
- **Mandatory Clearing and Trading.** Mandatory clearing and trading on or through designated contract markets, national securities exchanges, or swap execution facilities is mandated for swaps designated for clearing by the SEC or CFTC, a group that is expected to include most swaps that are currently traded. A limited exception to clearing and trading requirements exists for swaps entered into by end-users hedging commercial risk, and an exception to trading requirements exists for swaps that are not accepted by any trading facility.
- **End-User Exemptions.** A commercial end-user exemption from mandatory clearing and trading exists. However, due to the lack of a corresponding exemption from margin requirements, the scope and effect of this exemption is unclear. Guidance through rulemaking or through future technical amendments to the Act will be required.
- **Swap Dealer and Major Swap Participant Regulation.** New requirements have been imposed on swap dealers as well as on a new category of non-dealer participants in derivatives markets—"major swap participants" ("MSPs"). In addition to mandatory clearing, these new requirements include yet-to-be determined position limits for certain trades,

1 In this White Paper, unless otherwise specified, both "security-based swaps" and "swaps" are generally referred to as "swaps," and other terminology from the legislation relating to swaps, such as "major swap participants" and "swap dealers," will, unless otherwise specified, include both the "swap" and "security-based swap" versions of such terms.

mandatory registration with either the CFTC or SEC (and sometimes both), real-time reporting of trades, enhanced recordkeeping requirements, and margin and capital requirements.

- **Capital and Margin Requirements.** Capital requirements apply to all trades executed by swap dealers and MSPs, and margin requirements apply to all uncleared trades executed by these entities, potentially including preexisting trades and trades with end-users. However, the parameters for these new capital and margin requirements are left to various regulatory bodies that have been given discretion in the Act to determine appropriate capital and margin requirements. As discussed below, the extent to which existing trades will be exempt from the new margin and capital requirements remains a major point of contention.
- **Position Limits.** The CFTC and SEC are authorized to prescribe position limits in order to reduce the likelihood of market manipulation, fraud, or undue speculation, with the limits established by the CFTC potentially applied on a class-wide basis.
- **The "Push-Out" Requirements.** Spin-off requirements, albeit more narrowly implemented than originally contemplated, will require depository institutions that qualify as swap dealers to move all derivatives activities into separately capitalized affiliates other than specifically permitted swaps activities. This requirement is expected to be effective two years after the enactment of the Act, although insured depository institutions may be given an additional transition period of up to 24 months to conform to the new requirement.[2]
- **Insurance Override.** States will not be able to regulate swaps—particularly, credit default swaps—as insurance. However, to a certain extent, states may be able to continue to apply gaming and bucket shop laws to swaps.
- **Obligations to Certain Entities Engaged in Derivatives Activities.** Swap dealers and MSPs that act as swap counterparties to certain governmental entities, pensions, and endowments will have new responsibilities with respect to these entities, including verifying their status as eligible contract participants, making efforts to determine that such entities are receiving independent guidance from knowledgeable advisors, and providing significant disclosure. Additional responsibilities will also be imposed on swap dealers who act as advisers to these entities, including a requirement to act in the best interests of the entities.
- **Trade Reporting.** Real-time reporting of virtually all swap transactions will be required. This requirement could significantly change how a number of swaps are priced and could negatively affect liquidity for certain types of derivatives.
- **Global Reach.** While the overall extraterritorial effect of the Act's swap provisions may be somewhat limited as to activities outside of the U.S., the Act does not expressly exempt non-U.S. persons from the requirements applicable to swap dealers or MSPs. Ultimately, however, the Act's reach may depend on future decisions by various regulatory bodies.
- **Timing.** Few provisions of the bill are effective immediately, and the title containing the majority of the swap regulations is not generally effective until 360 days after its enactment. Many provisions will become effective in stages. Depending on the provision, the CFTC, SEC, and other U.S. financial regulators will be required to spend the next six to 18 months issuing the required implementing rules and regulations. During this time, market participants will be in the difficult position of having to make strategic decisions in an environment of continued regulatory uncertainty.
- **Implementation Process.** The regulatory implementation will be a dynamic process. Among other things, regulators will need to conform the required regulations to a follow-on technical bill that has been promised by Congressman Frank and Senator Dodd. The regulatory process will also be affected by actions being taken in other countries—particularly the E.U.—which will be implementing their own regulatory changes.

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[2] We note that (i) the transition period for a particular entity may be extended for an additional 12 months in some circumstances, and (ii) some uncertainty exists as to whether the transition period begins running at the enactment of the Act or at the effective date of the push-out provision. Additionally, some observers have suggested that Congress may have intended that the effective date of the push-out provision would be two years from the date the derivatives title is effective rather than two years from the date the Act is enacted (effectively creating a three-year period prior to effectiveness, as the derivatives title generally becomes effective 360 days after enactment). However, the current language of the provision looks to the date the Act is enacted rather than the date the derivatives title is effective.

DO WE FINALLY HAVE CLARITY AS TO HOW SWAPS ARE DEFINED AND WHO IS RESPONSIBLE FOR REGULATING THEM?

The Act divides the world of derivatives into four categories: "swaps," "security-based swaps," "mixed swaps," and everything else. However, the historical complexity of determining into which "bucket" a particular derivative transaction falls, and thus, who has regulatory authority over a given swap, remains as complicated as ever.

What is a Swap? A "swap" is defined very broadly. With certain exceptions, it includes virtually all OTC derivatives transactions. Included are interest rate, currency, foreign exchange, credit, equity, commodity, weather, energy, metal, agricultural, and index swaps. Puts, calls, caps, floors, and collars are also generally included. Swaps are governed by the CFTC.

Given how broad the definition of "swap" is, it is perhaps easier to consider what is *not* a swap. The definition excludes "security-based swaps," exchange-traded futures, contracts for the sale of commodities for future delivery (or options thereon), physically settled forwards (and options thereon), and exchange-traded options on currencies and certain securities contracts.

What is a Security-Based Swap? A security-based swap is a "swap" (as defined above, disregarding the exclusion of security-based swaps from such definition) based on a narrow-based security index (including an interest therein or on the value thereof), a single security or loan (including an interest therein or on the value thereof), or certain events relating to a single issuer or narrow group of issuers. Options, forwards, and credit default swaps referencing corporate bonds and loans are included. Because security-based swaps are excluded from the definition of "swap," they are regulated by the SEC rather than the CFTC.

A swap that otherwise meets the definition of "security-based swap" will nevertheless be excluded if it references or is based on a government or other exempt security and is not a put, call, or other option. That is, swaps on government securities will be regulated by the CFTC and not the SEC.

Mixed Swaps. This third category includes derivative transactions that have characteristics of both swaps and security-based swaps. The Act grants the SEC and CFTC joint authority, in consultation with the Federal Reserve, over mixed swaps.

What is Excluded? Puts, calls, straddles, options, or privileges on securities that are subject to the Securities Act and the Exchange Act, exchange-traded options on currencies, securities futures products, and securities agreements are neither swaps nor security-based swaps. They nevertheless continue to fall within the definition of "security" under the Exchange Act. Contracts for the sale of commodities for future delivery (or options thereon) and forwards on nonfinancial commodities and securities that are intended to be physically settled (and options thereon) are also excluded. Agreements, contracts, or transactions with a federal reserve bank, the federal government, or a federal agency that is expressly backed by the full faith and credit of the United States are excluded as well.

Special Treatment for Foreign Exchange Swaps and Forwards. Foreign exchange swaps and forwards fall within the definition of "swaps" and are thus under the jurisdiction of the CFTC. However, the Act gives the Treasury Secretary the authority to exempt forward exchange swaps and forwards from regulation by the CFTC. To grant such an exemption, the Treasury Secretary will be required to determine that such transactions should not be regulated as swaps and that they were not structured in a manner designed to evade Title VII of the Act. In making such a determination, the Treasury Secretary will be required to consider whether the required trading and clearing of such swaps would create systemic risk, lower transparency, or threaten U.S. financial stability; to assess the extent to which such swaps are subject to adequate oversight by regulators; to consider whether adequate payment and settlement systems exist for such swaps; and to assess whether an exemption for foreign exchange swaps and forwards could be used to evade otherwise applicable regulatory requirements.

Much political debate surrounded foreign exchange swaps and forwards as the Act was being drafted, resulting in conflicting positions between the House and Senate. The final

compromise was to keep these trades within the definition of a "swap" but to give the Treasury Secretary the power to exempt these trades from CFTC regulation. Nevertheless, even if the Treasury Secretary does indeed determine to exempt these trades from CFTC oversight, under the Act, parties that are swap dealers or MSPs entering into OTC foreign exchange swaps and forwards will be subject to certain business conduct standards. These swaps will also be subject to the Act's reporting requirements. Foreign exchange swaps and forwards that are cleared through a derivative clearing organization ("DCO") or traded on a designated contract market or through a swap execution facility would also remain subject to regulations prohibiting fraud and market manipulation.

What is Still Ambiguous? Elements of ambiguity and uncertainty remain in the various definitions. Not all swaps will fit easily into one category or another. For example, equity swaps and equity index swaps are defined as swaps, which gives the CFTC jurisdiction over these types of trades. However, as discussed above, a security-based swap, which is under the jurisdiction of the SEC, is defined as a swap based on, among other things, a single security or narrow-based index. Therefore, given that neither the Act, nor the Securities Act and Exchange Act, include separate definitions for "equity swaps" and "equity index swaps," a derivative transaction written on an equity could be characterized as an "equity swap" and thus a "swap" (regulated by the CFTC), as a "security-based swap" regulated by the SEC, or as both (with the CFTC and SEC each asserting jurisdiction). We will have to wait and see whether any clarity via rulemaking emerges.

Credit default swaps and total return swaps can be either security-based swaps or swaps depending on whether they reference a single security or narrow-based index, in the case of the former, or a broad-based index, in the case of the latter. Thus, whether the SEC or CFTC has jurisdiction over a particular credit default swap or total return swap will be dependent on whether it falls on the narrow-based or broad-based side of the divide. Further complicating matters, some types of these swaps, such as basket credit default swaps, could be considered either packages of individual swaps, which would suggest that such swaps should be governed by the SEC, or single swaps on a group of securities/issuers, which would suggest that such swaps should be governed by the CFTC.

Another example of ambiguity remaining in the definitions is the treatment of physically settled forward contracts on nonfinancial commodities. These contracts are excluded from the definition of "swap" as long as the parties to the swap "intend" for it to be physically settled. Absent clarity through the rulemaking process, there is presently no guidance as to how the intent to physically settle should be ascertained.

Revisions to Securities Laws. In 2000, the Commodities Futures Modernization Act severely limited the extent to which the SEC could regulate security-based swaps. Those limitations have now been repealed. Security-based swaps are now specifically included in the definition of "security" under both the Securities Act and the Exchange Act.[3]

Like securities, security-based swaps will now be subject to the Securities Act registration requirements, the antifraud provisions of the Securities Act and the Exchange Act, and, in the case of registered broker-dealers, the Exchange Act's requirements with respect to margin, capital, and books and records. As a result of these and other changes made by the Act, security-based swaps will no longer be able to be offered or sold to persons who are not "eligible contract participants" unless sold on a registered basis. Additionally, any security-based swap offered by or on behalf of the issuer of the security covered or referenced by the security-based swap will also be subject to registration. Going forward, this provision of the Act may subject many security-based swaps to SEC registration. To give effect to this requirement, the definitions of "purchase" and "sale" under the Securities Act have been amended to include the execution, termination prior to final maturity, assignment, exchange, or other similar

3 On the other hand, the Act provides that "security-based swap agreements" do not include "security-based swaps" for purposes of antifraud laws. Instead, the Act separately applies antifraud provisions to security-based swap agreements. Because the Gramm-Leach-Bliley Act, which was part of the Commodities Futures Modernization Act, "carved out" swaps from SEC oversight, a new definition of "security-based swap agreement" was then created in order to subject certain swaps to the antifraud, anti-manipulation, and insider trading prohibitions of the Securities Act and the Exchange Act. It appears that in retaining the separate definition of security-based swap agreements and separately applying the antifraud provisions to such agreements, Congress intended to ensure that swaps based on broad groups of securities or securities indices (which are not security-based swaps) are nevertheless subject to the antifraud provisions of the securities laws.

transfer or conveyance of a security-based swap, or the extinguishing of rights or obligations thereunder.

Bringing security-based swaps within the definition of a security under the Securities Act and the Exchange Act still leaves open the extent to which security-based swaps will be regulated as securities for all purposes or only to the extent the statutes have been expressly made applicable pursuant to the Act. This remaining question may take on greater importance given the lack of clarity (as discussed elsewhere) as to whether certain derivative trades will be treated as swaps or as security-based swaps.

Revisions to Commodities Laws. As part of the overall regulatory restructuring, the Act now precludes any person, other than an eligible contract participant, from entering into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market. Further, the Act expands the CFTC's regulatory authority over swaps. In addition to the authority the CFTC historically has had with respect to cash market transactions and futures, the CFTC now has explicit antimarket manipulation oversight with respect to swaps, and the revised antimanipulation provisions include prohibitions on false reporting and the provision of false information. Further, the CFTC no longer has to prove "specific intent" to manipulate markets. It will now be sufficient to establish "reckless disregard."

Other changes to the commodities laws include the expansion of the definitions of "commodity trading advisor," "futures commission merchant," and "commodity pool operator" to include persons who provide advice or brokerage services with respect to, or that operate funds that trade in, swaps and certain other nonfutures products.

Changes to Disclosure Requirements. The Act provides that persons may be deemed to acquire beneficial ownership of equity securities for certain purposes by entering into security-based swaps as designated by future SEC rulemaking. If the SEC determines, in consultation with other regulators and the Treasury Secretary, that the purchase of certain security-based swaps gives the purchaser incidents of ownership comparable to direct ownership of the underlying security, and that to achieve the purposes of Section 13 of the Exchange Act the purchase of a security-based swap must be deemed to constitute the purchase of a beneficial ownership in the underlying security, the SEC will be entitled to require disclosure of such positions for purposes of Sections 13(d), 13(f), and 13(g). The Act adds a new subsection (o) to Section 13(d) to give effect to the foregoing. The SEC also has a similar option to apply the provisions of Section 16 of the Exchange Act to the acquisition of security-based swaps.

Trumping State Laws. The Act prohibits swaps and security-based swaps from being regulated as insurance contracts under state law. This provision of the Act puts a halt to the efforts of some state insurance regulators to regulate credit default swaps as insurance contracts under state law. The Act also prohibits states from applying state gaming and bucket shop laws to invalidate any security-based swap between eligible contract participants or any security-based swap effected on a national securities exchange. Interestingly, the Act contains no comparable provision with respect to swaps governed by the CFTC. This could raise questions as to the legality of some swaps under state laws whether or not entered into by eligible contract participants. State laws, other than state antifraud laws, governing the offer, sale, or distribution of securities that are security-based swaps or securities futures products are also preempted by the Act.

Practical Considerations. The split of regulatory authority between the SEC and CFTC contained in the Act creates an ongoing layer of uncertainty and complication for entities engaging in derivatives transactions. As discussed above, questions may arise regarding whether particular contracts are swaps or security-based swaps (or, perhaps, both or neither). The SEC and CFTC, notwithstanding the fact that the Act mandates that they coordinate their rulemaking, may well take opposing views regarding a particular swap, putting that swap in some degree of limbo until the regulatory disagreement is resolved. In addition, since many of the products to be regulated have similar features but will be regulated by two different agencies with historic differences of approach and opinion, it is possible that very similar types of products could be regulated differently based on the regulatory body having jurisdiction over the particular product.

MANDATORY CLEARING

A fundamental goal of the legislation is to push as many trades as possible into clearinghouses. The Act requires the clearing of all swaps that the CFTC or SEC determines should be cleared and that are accepted for clearing by a DCO for swaps or by a clearing agency for security-based swaps. The legislation provides for an ongoing review of swaps by the CFTC and security-based swaps by the SEC to determine which categories of swaps or security-based swaps are suitable for clearing. The SEC and CFTC must publish such determinations and provide for a subsequent comment period. Each DCO or clearing agency must submit to the SEC or CFTC, as applicable, (as well as to their own members) lists of swaps such DCO or clearing agency intends to clear. The applicable regulatory body must review and publish such lists for a 30-day public comment period and must generally make a determination within 90 days of receipt of the submission (during which time the clearing requirement may be stayed).

In determining which swaps must be cleared, the CFTC and SEC are required to take into account, among other factors: notional exposures, trading liquidity, and adequate pricing data; the availability of rule framework, capacity, operational expertise and relevant infrastructure to clear the swap contract in accordance with its current terms and trading conventions; the effect on the mitigation of systemic risk and on competition; and the existence of reasonable legal certainty, in the event of the insolvency of the relevant clearinghouse or its clearing members, with regard to the treatment of customer and swap counterparty positions, funds, and property. Swaps outstanding prior to the effective date of the clearing requirement will not be required to be cleared. However, such swaps must comply with the reporting requirements that apply to uncleared swaps.

The Act does not force DCOs or clearing agencies to accept any swap for clearing, and a DCO/clearing agency can refuse to accept a swap for clearing if doing so would threaten its financial integrity. Early proposals with respect to clearing tended to identify which swaps would be required to be cleared based on whether the terms of the particular swap were sufficiently standardized to appropriately allow for clearing. As enacted, the Act does not expressly limit mandatory clearing to swaps with standardized terms. Therefore, whether a swap is ultimately mandated to be cleared and is, in fact, accepted for clearing by a DCO/clearing agency is likely to be based in significant part (at least initially) on whether the swap is clearable under existing clearing technology, whether sufficient valuation data exists, and whether sufficient liquidity exists for the particular category of swap.

Market participants are very likely to be members of multiple DCOs or clearing agencies. How netting and margin posting across clearing platforms are intended to work will have to be addressed in the rulemaking process. These issues may be particularly complex to the extent the DCOs or clearing agencies are located in multiple countries.

The Commercial End-User Exemption. Under the Act, there is an optional exemption from clearing available to any swap counterparty that:

- is not a financial entity,
- is using the swap to hedge or mitigate commercial risk; and
- notifies the CFTC or SEC how it generally meets its financial obligations associated with entering into uncleared swaps.

For this provision, the term "financial entity" means a swap dealer, an MSP, a commodity pool, a private fund, an employee benefit plan, or a person predominantly engaged in the business of banking or in activities that are financial in nature. The definition of "financial entity" for purposes of a swap (but not a security-based swap) excludes certain captive finance companies, and the CFTC and SEC are authorized to exempt small banks and certain other entities from the definition of financial entity.

Any end-user choosing to take advantage of this clearing exemption must first obtain approval from an appropriate committee of its board of directors if it has outstanding securities registered under the Securities Act or is a reporting entity under the Exchange Act.

Grandfathering and Reporting Requirements for Uncleared Swaps. Swaps entered into before the date of enactment of the Act are exempt from the clearing requirement as long as they are reported to a swap data repository or to the applicable regulatory body within a specified time period.

Unfortunately, this time period is slightly unclear—one provision of the Act states that preexisting swaps must be reported within 30 days of the issuance of the interim final rule relating to the reporting of preexisting swaps (which must be issued within 90 days of the enactment of the legislation), and another provision states that preexisting swaps must be reported within 180 days of the "effective date." For this purpose, "effective date" means 360 days after enactment of the legislation. A swap entered into on or after the effective date of the Act but prior to any determination by the CFTC or SEC that such swap is subject to mandatory clearing is exempt if it is reported within the later of 90 days of the effective date described above or such other time frame specified by the applicable regulatory body.

Mandatory Execution on Specified Platforms. The Act requires that all swaps that are subject to the clearing requirement be traded on a board of trade designated as a contract market or a securities exchange or through a swap execution facility, unless no such entity accepts the swap for trading. Trades may be executed other than on an exchange or through a swap execution facility if the clearing requirement does not apply. Therefore, trades that are not required to be cleared and trades with a nonfinancial entity that are exempt from clearing due to the commercial end-user exception are not subject to the mandatory execution requirement.

A swap execution facility is a new designation for a trading system or platform other than a designated contract market or national securities exchange pursuant to which multiple participants can execute or trade swaps by accepting bids and offers made by other participants. If this definition is interpreted to exclude electronic trade execution or voice brokerage facilities that facilitate the trading of swaps between two (rather than multiple) persons, it would significantly limit the platforms on which trades can be executed and could as a result potentially impair market liquidity.

ARE YOU COVERED BY THE ACT?

If you are a swap dealer or major swap participant, definitely. If you are a financial entity or end-user, the answer is more complicated. The Act divides the world of participants in the derivatives markets into newly designated categories, and the extent to which many of the new requirements of the Act apply will depend, in part, on the category into which a market participant falls.

What is a Swap Dealer? The Act defines "swap dealer" as any person that

- holds itself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
- engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

A "security-based swap dealer" is similarly defined by substituting "security-based swap" in lieu of "swap." An entity may be designated as a swap dealer or security-based swap dealer in respect of a single type, class, or category of swap (or security-based swap). The definition excludes a person that enters into swaps for its own account, individually or in a fiduciary capacity, "but not as part of a regular business." The Act does not define what would be considered "part of a regular business." This is likely to be a fact-based analysis and, thus, it is unclear whether the CFTC or SEC will attempt to define the concept or otherwise provide guidance.

An insured depository institution will not be considered a "swap dealer" to the extent it offers to enter into a swap with a customer in connection with a loan being made to that customer. However, there is no comparable exception for depository institutions from the definition of "security-based swap dealer." Because, as noted above, swaps covering or referencing loans are treated under the Act as security-based swaps, a depository institution that enters into total return or credit default swaps on loans may need to register as a security-based swap dealer unless such swaps are deemed to have been entered into for hedging or mitigating risks directly related to the activities of the institution, and the institution is not otherwise holding itself out as a dealer in security-based swaps or making a market in such swaps. The Act does give regulators discretionary authority to allow depository institutions to enter into in a *de minimis* amount of swap and security-based swap transactions in connection with transactions with or on behalf of its customers without being treated as a swap dealer or security-based swap

dealer, respectively. The parameters as to what will be considered *de minimis* will be determined through CFTC and SEC rulemaking.

Because the Act amends the definition of "dealer" under the Exchange Act, dealers in security-based swaps with eligible contract participants do not need to register as broker-dealers. Unfortunately, however, no similar exemption exists for persons acting as brokers of security-based swaps.

What is a Major Swap Participant? A "major swap participant" is defined under the Act as any non-swap dealer:

- that maintains a substantial position in swaps for any of certain major swap categories that are to be determined by the CFTC (excluding positions (i) held for hedging or mitigating commercial risk and (ii) maintained by an employee benefit plan under ERISA for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan);
- whose 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
- that is a financial entity[4] that (i) maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC, (ii) is highly leveraged relative to the amount of capital it holds, and (iii) is not subject to capital requirements established by an appropriate U.S. banking regulatory body.

"Major security-based swap participant" is similarly defined by substituting "security-based swap" in lieu of "swap" and "SEC" in lieu of "CFTC." As is the case with swap dealers, designation as a major swap participant or major security-based swap participant can apply to a single type, class, or category of swap (or security-based swap).

Subject to criteria specified in the Act, captive finance companies that provide financing for products produced by an affiliate and that use derivatives to hedge commercial risk related to interest rate and currency exposures are exempt from the definition of MSP (but not from the definition of major security-based swap participant).

There are no particular jurisdictional limits in determining whether an entity is an MSP. That is, a non-U.S. entity that engages in significant derivatives-trading activities within the U.S. or with U.S. persons could, in theory, be deemed to be an MSP and, accordingly, subject to these new requirements.

Questions Raised by MSP Definition. The definition of an MSP set forth above raises many as-yet-unanswered questions. It is left to the regulators to determine what constitutes a swap "held for hedging commercial risk"; what "substantial counterparty exposure" means; what factors are to be used to determine whether an exposure that "could have serious adverse effects" exists; and what "highly leveraged" means.

The regulators will also determine what constitutes a "substantial position," although in this case they at least have some guidance. The legislation requires the CFTC and SEC to each provide a definition of "substantial position" that is "prudent for the effective monitoring, management and oversight of entities that are systemically important or can significantly impact the financial system of the United States." Among factors to be considered (including any other criteria the CFTC and SEC wish to apply) are the value and quality of collateral held against counterparty exposure as well as the relative sizes of the entity's cleared and uncleared swap portfolios.

As a result of the many unanswered questions raised by the MSP definition and the generally broad nature of the drafting of this provision, many entities may not know if they must comply with the MSP requirements until the regulations are issued. Others may assume that they are not affected, only to find out later that the applicable regulator has taken a different view. Further, depending on how the regulations are written, it may be possible for an entity to float in and out of MSP status (for example, as a result of its level of swap holdings or leverage), with no clear guidance as to how this would be addressed and whether such an entity could deregister to escape the regulatory regime when it no longer qualifies.

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4 "Financial entity" is not specifically defined in connection with MSPs. However, elsewhere in the Act, a financial entity is defined to include hedge funds, commodity pools, certain employee benefit plans, and entities predominately engaged in activities that are in the business of banking or financial in nature, as defined in the Bank Holding Company Act.

The fact that a person could be designated as an MSP for one type, class, or category of swaps and not for another will likely be an additional complicating factor. Entities with large swap books may lack sufficient guidance as to which swaps are deemed to be swaps related to hedging commercial risks and which swaps fall into investment or speculative categories. Certainly, entities such as hedge funds which have large numbers of swap positions but little or no commercial risk (as likely to be defined by regulators) are likely to be deemed MSPs for at least some of their swap activity. Even large corporate or commercial entities risk being designated as MSPs for certain swap activities. In addition, note that as a result of the overly general language contained in the legislation, there may be no statutory basis for challenging a determination of MSP status by the CFTC or SEC.

Registration and Reporting. Swap dealers and MSPs will be required to be registered with the applicable regulator and will be subject to new regulatory requirements for recordkeeping, reporting, supervision, position limits, business conduct standards, disclosure (including conflicts of interest), capital and margin retention and posting, and examination provisions. The CFTC and SEC are required to issue rules for registration within one year of the Act's passage.

No Grandfathering. The Act does not, on its face, exempt persons who currently hold swaps from being treated as MSPs based on such preexisting holdings, whether or not they have any ongoing involvement in the swap markets. In addition, MSPs' preexisting swap holdings are not explicitly grandfathered by the Act and may be subject to minimum capitalization requirements and initial and variation margin requirements for outstanding uncleared swap positions as discussed below. Although the Act prohibits regulators from exempting MSPs from the registration and other requirements prescribed for MSPs, the regulators do have the power to further define what constitutes an MSP by regulation.

CAPITAL AND MARGIN REQUIREMENTS

Swap dealers and MSPs will be subject to capital requirements. Additionally, swap dealers and MSPs will be subject to initial and variation margin requirements on all uncleared swaps. The capital and uncleared swap margin requirements for banking entities that are swap dealers or MSPs will be determined by the applicable prudential regulator in consultation with the CFTC and SEC. For nonbank entities, the capital and uncleared swap margin requirements will be determined by the CFTC and the SEC. With respect to cleared swaps, the margin requirements will be those contained in the rules of the DCO or the clearing agency, as applicable.

What is the Level of Margin that Must be Provided? As noted, the amount of margin for uncleared swaps will be determined by the appropriate regulatory body. In making such determinations, the Act requires the margin requirements to (i) help ensure the safety and soundness of the swap dealer or MSP and (ii) be appropriate for the risk associated with the entity's uncleared swaps. Non-cash collateral will be permitted to meet margin requirements if it is determined that doing so will be consistent with preserving the financial integrity of the markets trading swaps and the stability of the U.S. financial system.

What is the Level of Capital that is Required? The appropriate regulatory body will determine the capital requirements for each entity, again focusing on ensuring the safety and soundness of the entity and making a determination appropriate for the risk associated with the entity's uncleared swaps. However, it is important to note that, in setting capital requirements for an entity, the regulatory bodies are required to consider the risks associated with all swap and other activities of the swap dealer or MSP, not just the risks related to those types, classes, or categories of swaps that caused such entity to qualify as a swap dealer or MSP in the first place.

No Express Grandfathering for Margin. The Act does not expressly provide for grandfathering with respect to capital or margin requirements for existing swaps. This has been a point of significant criticism and debate for a number of market participants. It is possible that the regulatory bodies, in carrying out their duties to establish the margin requirements, will have the ability to exempt certain existing trades from the new margin requirements. Although the Act prohibits exemptions from the requirements of the relevant sections of the legislation, it does not appear to preclude regulatory bodies from setting the margin and capital requirements lower for existing transactions or determining

that the margin and capital requirements for existing trades remain the same as the requirements that were applicable to such trades prior to the enactment of the Act. If such adjustments are made, it is not clear whether such exemptions will be implemented on a broad or a case-by-case basis.

No Express Margin Exemption for End-Users. The Act does not expressly exempt from the margin requirements end-user swap counterparties that are otherwise exempt from the clearing requirements. However, a June 30, 2010 letter from Sen. Dodd (D-CT) and Sen. Lincoln (D-AR) to Rep. Frank (D-MA) and Rep. Peterson (D-MN) stated that it is not the intent that such nonfinancial swap counterparties be subject to the margin requirements. In discussing the Act's end-user clearing exemption, the Dodd-Lincoln letter states:

> The legislation does not authorize the regulators to impose margin on end-users, those exempt entities that use swaps to hedge or mitigate commercial risk. If regulators raise the costs of end-user transactions, they may create more risk. Its is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end-users or impair economic growth.

While the letter is a helpful clarification as to the intent of the Conferees, it is important to remember that it has no legally binding effect. In fact, when the Act was resubmitted to the Conference Committee in order to address the funding aspects of the Act, the Republican conferees attempted to add an amendment to the Act to clarify the margin requirements. This attempt was rebuffed by the Democrat conferees who stated that the clarification could subsequently be addressed by a technical amendment. The Republican conferees, in turn, expressed significant skepticism that any clarifications to the margin provisions would merely require a technical amendment as opposed to substantive changes to the Act. The Dodd-Lincoln letter was issued as a result of this heated debate.

Likelihood of Margin Exemptions or Reductions. As noted above, there is no explicit carve-out in the Act for existing swaps or end-user swaps from the margin requirements, and a separate provision of the Act appears to prohibit exemptions from the margin provisions contained in the legislation. On the other hand, there is also no provision in the Act that affirmatively directs regulators to retroactively apply new margin and capital requirements to existing swaps. The status of any exemptions or reductions in margin requirements for existing swaps or end-user swaps is therefore unclear.

The Dodd-Lincoln letter certainly suggests that the regulators did not intend to impose margin requirements on end-users, and one assumes that this intent applied to both existing and new end-user swaps. Further, the Dodd-Lincoln letter separately expresses a Congressional intent to avoid significant disruption to existing contracts, stating that "it is imperative that we provide certainty to … existing contracts for the sake of our economy and financial system." This statement of Congressional intent relating to legal certainty for existing swaps could potentially be used to support a decision by regulators to minimize the imposition of margin on all preexisting swaps if the regulators interpret their rulemaking authority to allow a determination that small or no margin and capital requirements may be imposed in these instances. Additional statements in the Dodd-Lincoln letter could also be read to support such an interpretation:

> It is also imperative that regulators do not assume that all over-the-counter transactions share the same risk profile. While uncleared swaps should be looked at closely, regulators must carefully analyze the risk associated with cleared and uncleared swaps and apply that analysis when setting capital standards on Swap Dealers or Major Swap Participants. As regulators set capital and margin standards on Swap Dealers or Major Swap Participants, they must set the appropriate standards relative to the risks associated with trading. Regulators must carefully consider the potential burdens that Swap Dealers and Major Swap Participants may impose on end-user counterparties—especially if those requirements will discourage the use of swaps by end-users or harm economic growth. Regulators should seek to impose margins to the extent they are necessary to ensure the safety and soundness of the Swap Dealers and Major Swap Participants.

Further, in addition to these statements in the Dodd-Lincoln letter, Congressmen Peterson and Frank separately stated

that they expected the level of margin required by regulators for swap dealers and MSPs to be minimal, in keeping with the greater capital that swap dealers and MSPs will be required to hold. These statements suggest that Congress intended to give regulators sufficient flexibility to assess appropriate margin levels based on assessments of relative risks associated with trading. On that basis, it may not be unreasonable to assume that the risk associated with preexisting swaps may not rise to the same level as future, ongoing swap activities and that the risk of discouraging the use of swaps by end-users by the imposition of large margins on such parties outweighs the potential benefits.

On the other hand, regulators could interpret their mandate to adopt rules requiring margin as allowing no exceptions to the margin provisions and little leeway in setting different margin requirements for preexisting or end-user swaps, given the separate provisions of the Act that provide that the SEC and CFTC may not provide exemptions from the capital and margin requirements.

It is also possible (although perhaps unlikely) that Congress will adopt a technical amendment to address the margin requirements for end-user swaps and, potentially, all preexisting swaps.

Holding and Segregation of Collateral. A person holding margin for customers with respect to DCO-cleared swaps must register with the CFTC as a futures commission merchant. Persons holding margin for clearing agency-cleared security-based swaps for customers must register as brokers, dealers, or as security-based swap dealers with the SEC. The collateral held must be segregated, and the use of such collateral will be subject to rules to be issued by the CFTC or SEC, as applicable. These requirements do not apply to uncleared swaps. However, upon request by a counterparty on an uncleared swap, initial margin (but not variation margin) must be maintained in a segregated account with an independent third-party custodian. If a counterparty does not request collateral segregation, the collateral holder must provide quarterly certifications to the counterparty that the collateral is being held and maintained in accordance with the terms of the applicable contractual agreement with the counterparty.

POSITION LIMITS

Under the Act, the CFTC is empowered and directed to establish position limits on the aggregate number or amount of positions that can be held by any one person or group or class of persons in contracts based on the same underlying commodity. These aggregate limitations apply to each month across all (i) contracts traded on a designated contract market, (ii) contracts traded on a foreign board of trade that grants direct access to participants located in the U.S., and (iii) economically equivalent swaps that perform a significant price discovery function. In addition to such aggregate contract position limits, the CFTC is required by the Act to establish position limits on all physical commodity positions held by any person for any spot month, any other month, or any combination of all months (other than bona fide hedging positions). The stated goal of such physical commodity limits is to avoid market manipulation and excessive speculation and to ensure sufficient market liquidity and price discovery functions. In establishing such position limits, the CFTC must attempt to prevent such limits from causing price discovery in the applicable commodity from shifting to a foreign board of trade.

The potential to set position limits across groups or classes of persons granted to the CFTC is somewhat unusual. Regulatory action will be needed to determine how these powers will be used, as it is unclear how a group or class position limit would be established and enforced.

For security-based swaps, the Act requires that the SEC establish limits, including related hedge exemption provisions, on the size of positions in any security-based swap that may be held by any person. Such limits can be applied to any person on an aggregate basis; that is, a person would be forced to aggregate the security-based swap and any related instruments. Accordingly, such aggregate position limits may be established, regardless of the trading venue, on any security-based swap and any other instrument correlated with, or based on, the same security or loan or group or index of securities as such security-based swap.

The CFTC and SEC are authorized to exempt any person or class of persons or any swap or class of swaps from such position limits. Preexisting positions are exempt from any new position limits imposed by the CFTC; however, this

exemption will cease to apply to any preexisting position increased after the effective date of the position limit.

VOLCKER RULE TRADING LIMITATIONS

The so-called Volcker Rule could have severe effects on the scope of derivatives activities undertaken by banks for their own accounts. The rule generally prohibits "banking entities"[5] from engaging in proprietary trading, which includes using the trading account[6] of the banking entity to purchase or sell, or otherwise acquire or dispose of any derivative or an option on any derivative, among other prescribed investments.[7] The Act defines "proprietary trading" as engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Federal Reserve in any transaction to purchase or sell, or otherwise acquire or dispose of, any security; any derivative; any contract of sale of a commodity for future delivery; any option on any such security, derivative, or contract; or any other security or financial instrument that the appropriate federal banking agencies, the SEC, and CFTC may determine through rulemaking.

Permitted Activities. Some exemptions are carved out of the Volcker Rule prohibition including: (i) trading in federal, state, or local government instruments or instruments issued by Fannie Mae, Freddie Mac, or certain other government-sponsored entities; (ii) trading derivatives in connection with underwriting or market-making-related activities, not to exceed the expected near-term demands of clients or counterparties; (iii) risk-mitigating hedging activities in connection with and related to individual or aggregated 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; (iv) trading of derivatives on behalf of customers; (v) proprietary trading by a foreign banking entity as long as the trading occurs solely outside of the U.S. and the banking entity is not directly or indirectly controlled by a banking entity organized in the U.S.; and (vi) such other activity as the regulators determine, by rule, would "promote and protect" the safety and soundness of the banking entity and U.S. financial stability.

Limitations of Permitted Activities. Even if an activity is a permitted activity, the Volcker Rule still prohibits such activity if it would (i) involve or result in a "material" conflict of interest (as defined by the SEC or CFTC) between the banking entity and its clients, customers, or counterparties; (ii) result, directly or indirectly, in a "material" exposure to high-risk assets or high-risk trading strategies (as defined by the SEC or CFTC); (iii) pose a threat to the safety and soundness of such banking entity; or (iv) pose a threat to U.S. financial stability. Moreover, the appropriate federal banking agencies, the SEC, and the CFTC will adopt rules imposing additional capital requirements and quantitative limitations, including diversification requirements, regarding the permitted activities if such agencies determine that additional capital and quantitative limitations are appropriate to protect the safety and soundness of banking entities engaged in such activities.

Implementation. None of the prohibitions, requirements, or limitations of the Volcker Rule will be effective until the earlier of (i) 12 months after the issuance of final rules implementing the rule; and (ii) two years after the date of enactment of the rule. After such effective date, there will be an initial two-year transition period during which banking entities must conform their activities and investments to be in compliance with the Volcker Rule. However, the Federal Reserve may grant up to three one-year extensions of the transition period, if "consistent with the purposes of this section" and "not detrimental to the public interest."

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5 "Banking entity" means any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act), any company that controls an insured depository institution or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity.

6 "Trading account" means any account used for acquiring or taking positions in derivatives 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 determine. Because the definition addresses only "near-term" transactions and "short-term" price movements, these limitations leave open the door for banks to engage in other types of proprietary trading.

7 We note that the Volcker Rule also prohibits banking entities from acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring, any hedge fund or private equity fund; these prohibitions are not the subject of this White Paper.

THE PUSH-OUT REQUIREMENT (THE SO-CALLED "LINCOLN AMENDMENT")

A much-debated and much-reported provision of the Act prohibits "swap entities" from receiving "federal assistance."

What is the Push-Out Requirement? The swap push-out requirement provides that "Federal Assistance" may not be provided to any swap entity (other than insured depository institutions limiting their swap activities to certain permitted activities) and that taxpayer funding may not be used to prevent the receivership of any swap entity resulting from the swap activities of such entity if it is an FDIC-insured institution or has been otherwise designated as systemically important. If such an entity becomes insolvent or is put into receivership as a result of its swap activities, its swaps must be either terminated or transferred, and any funds incurred in the termination or transfer of such swaps must be recovered through the disposition of assets or through other financial assessments. No taxpayer funds can be used in the liquidation of any swap entity that is not FDIC insured or systemically important.

The prohibition on federal assistance will go into effect two years following the enactment of the Act.[8] The insolvency/receivership rules appear to go into effect 360 days after the enactment of the Act.

What is a Swap Entity? "Swap entity" means any swap dealer or MSP, other than an MSP that is an insured depository institution. Insured depository institutions that are swap dealers are not excluded from the definition of "swap entity." Accordingly, an insured depository institution will be a swap entity only if it is a swap dealer. It should be noted that under the definition of "swap dealer," an insured depository institution is not considered to be a swap dealer to the extent it offers to, or otherwise enters into swaps with, a customer in connection with originating a loan with that customer. As a result, insured depository institutions whose swap activity is limited to providing such swaps would remain eligible for federal assistance without the need to push out such swap activities.

What is Federal Assistance? "Federal assistance" means any advance from any Federal Reserve credit facility or discount window other than in connection with programs having broad-based eligibility under Federal Reserve emergency lending powers, FDIC insurance, or guarantee, in each case, that is used for (i) making a loan to, or purchasing stock, an equity interest, or debt obligation of, a swap entity; (ii) purchasing the assets of a swap entity; (iii) guaranteeing any loan or debt issuance of a swap entity; or (iv) entering into any assistance arrangement, loss-sharing arrangement, or profit-sharing arrangement with a swap entity.

What is Required by the Push-Out Provisions? To avoid losing federal assistance, an FDIC-insured depository institution that is a swap dealer cannot enter into any swaps other than certain swaps permitted by the Act ("permitted swaps"), unless it spins out its swap dealer activities to a separately capitalized entity (which may be an affiliate controlled by the same bank holding company). The separate entity must be "ring-fenced" from the depository institution in accordance with the requirements of the Federal Reserve Act. Insured depository institutions that are subject to the push-out rule will have a transition period of up to 24 months following the date on which the federal assistance prohibition becomes effective (which may be extended by another 12 months) to divest or limit their swap activities to permitted swaps.[9] Any entity that chooses to remain a swap dealer but limit its activities to permitted swaps will do business subject to the Financial Stability Oversight Council's ability to terminate its federal assistance at any time if the council determines that other provisions of the Act are insufficient to mitigate systemic risks and protect taxpayers.

The CFTC, SEC, and Federal Reserve are required by the Act to issue rules governing the relationship between the insured institution and any affiliated swap entity. This rulemaking authority is quite broad. As a result, the nature of the ongoing relationship between insured depository institutions

8 Some observers have suggested that Congress may have intended that the effective date of the prohibition on federal assistance would be two years from the date the derivatives title is effective rather than two years from the date the Act is enacted (effectively creating a three-year period prior to effectiveness, as the derivatives title generally becomes effective 360 days after enactment). However, the current language of the provision looks to the date the Act is enacted rather than the date the derivatives title is effective.

9 We note again that some uncertainty exists as to whether the transition period begins running at the date of enactment of the Act or the effective date of the prohibition on federal assistance.

and their spun-off swap entities remains unclear. Also, it would appear that counterparties who have outstanding derivatives trades with depository institutions could be forced to have those derivatives trades assigned to such newly created swap entities or face having their trades terminated. It should also be noted that there does not appear to be any requirement that the newly created swap entity have the same credit ratings as its affiliated depository institution.

What are Permitted Swaps? Insured depository institutions will not be subject to the prohibition from receiving federal assistance if they limit their swap activities to the following types of swaps:

- swaps entered into for hedging or mitigating risks directly related to the activities of the institution; or
- interest rate and currency swaps, certain precious metal swaps, and swaps on any other assets that are permissible investments for national banks,[10] including cleared credit default swaps on investment-grade securities.[11]

PRACTICAL IMPLICATIONS OF THE PUSH-OUT PROVISION AND THE VOLCKER RULE

As discussed, the push-out provisions will restrict the swap activity of insured depository institutions that do not spin off their swap business. However, this will not be the only restriction on swap activities by insured depository institutions and their affiliates. Any spun-off entity that is an affiliate of an insured depository institution, as well as any insured depository institution that retains a swap business but limits it activities to permitted swaps, will remain subject to the Volcker Rule, limiting the swap activities either type of entity may undertake. Further, any spun-off entity will have to independently satisfy the capitalization standards and other requirements set forth in the Act for a swap dealer, and it will have to be sufficiently capitalized to qualify as a participant in a clearing organization and to obtain a credit rating sufficient for counterparties to be willing to transact with the entity. The level of capitalization required to satisfy these requirements will be high; many insured depository institutions may not have the required funds or may determine that the establishment of an affiliated swap entity is not the best use of their funds. The combination of these factors may result in significantly fewer large swap counterparties willing and able to enter into swaps, potentially affecting the liquidity of the market for swaps.

NEW STANDARDS OF CONDUCT AND REAL-TIME REPORTING REQUIREMENTS

Under the Act, swap dealers and MSPs will be required to comply with new business conduct standards to be promulgated by the CFTC and SEC. Swap dealers and MSPs will be obligated to verify that their counterparties meet the eligibility standards for eligible contract participants and to disclose (to counterparties other than swap dealers or MSPs) (i) information about the material risks and characteristics of a proposed swap; (ii) material incentives and conflicts of interest the swap dealer or MSP may have in connection with a proposed swap; and (iii) receipt of the daily mark of the swap. Communications will be subject to a standard of fair dealing and good faith. Until the regulations have been promulgated, it is unclear how onerous some of these requirements will be, but certain requirements (especially disclosure requirements) could impose significant new obligations on swap dealers and MSPs that could cause these counterparties to be less willing to provide swaps to parties that are not swap dealers or MSPs, or to charge more for such swaps.

In addition to the business conduct standards, the Act requires reporting rules to be developed by the CFTC and SEC, including "real-time public reporting"[12] for swap transactions and, more importantly, pricing data. While the exact

10 National banks can invest in such assets as loans, notes and other extensions of credit, foreign currency, gold and other precious metals, U.S. government obligations, certain investment company shares, marketable investment-grade debt securities, and other similar obligations. National banks may not, however, deal in equity securities.

11 Some commentators have questioned whether U.S. branches of non-U.S. banks, given that they are noninsured banking institutions, will be able to continue engaging in these types of activities, since the Act now states that they are only permitted in the case of "insured depository institutions." However, unless such branches are somehow deemed to be receiving "federal assistance," these trading activities should continue to be permissible by non-U.S. banks and their U.S. branches.

12 Although we believe real-time reporting is intended for all swaps, the provisions implementing this requirement contain what appear to be incorrect cross references, calling into question exactly which uncleared swaps will be subject to the real-time reporting provisions.

timing for reporting and the form the reporting will take is to be addressed through rulemaking, the real-time reporting mandate requires reporting of data relating to a swap as soon as is technologically practicable following execution. The extent to which detailed pricing data on a trade-by-trade basis must be disclosed remains to be seen. For uncleared swaps, the trade data reported must be made publicly available on a real-time basis but in a manner that does not disclose the details of the business transactions or market positions of any person. Trade reporting also cannot identify the counterparties. The timing for the issuance of reports for block trades may be delayed. The effects of these new requirements will not truly be known until the regulations have been developed, but real-time reporting of pricing for uncleared swaps could potentially collapse the bid-ask spread on such swaps, causing dealers to be less willing to engage in such swaps.

Duties to Special Entities. Swap dealers and MSPs may be subject to additional standards of conduct based on the identity of their counterparties. Swap dealers and MSPs that advise "special entities" (which include municipalities, pension funds, retirement plans, and endowments) are prohibited from engaging in fraud, deception, or manipulation with respect to any transaction involving such special entity. Additionally, when advising special entities, swap dealers and MSPs have a duty to act in the "best interests" of the special entity and to undertake reasonable efforts to obtain information about the special entity as may be necessary to make a reasonable determination as to whether any proposed swap is in the best interests of the special entity given its financial position, tax status, and investment objectives.

When entering into a swap with a special entity, a swap dealer or MSP will be obligated to comply with CFTC and SEC rules that require the swap dealer or MSP to have a reasonable basis to believe that the special entity counterparty has a qualified independent representative that (i) has sufficient knowledge to evaluate the transaction and the risks; (ii) is not subject to statutory disqualification; (iii) is independent of the swap dealer or MSP; (iv) undertakes a duty to act in the best interests of the special entity counterparty; (v) makes appropriate disclosures; and (vi) will provide representations in writing to the special entity regarding the fair pricing and appropriateness of the swap. Before entering into a swap transaction with the special entity, the swap dealer or MSP must disclose in writing the capacity in which it is acting. These requirements do not apply to swaps initiated by a special entity on an exchange or swap execution facility or swaps in which the swap dealer or MSP does not know the identity of the special entity swap counterparty.

EXTRATERRITORIAL EFFECT

The Act's provisions on swaps do not generally apply to activities outside the United States. However, the provisions relating to swaps regulated by the CFTC do apply to activities outside the United States that: (i) have a direct and significant connection with activities in, or effect on, commerce of the United States or (ii) contravene CFTC anti-evasion rules. The provisions related to security-based swaps apply to activities outside the United States only if such activities are conducted in contravention of the SEC anti-evasion rules. The CFTC and SEC are empowered (but not required) to implement such rules as they deem necessary or appropriate to prevent evasion of any provision of U.S. commodities and securities laws.

It is very possible that the CFTC and SEC will interpret their respective jurisdictional reach sufficiently broadly so as to apply to non-U.S. persons transacting with U.S. market participants or executing or clearing swap transactions on or through a U.S. facility. Additionally, as noted in the discussion of MSPs, there are no explicit exemptions or exceptions from swap dealer and MSP registration and regulation with respect to non-U.S. financial institutions or other non-U.S. persons.

Additional restrictions on foreign entities are also possible under the Act. The Act provides that the CFTC or the SEC, in consultation with the Treasury Secretary, may prohibit an entity domiciled in the foreign country from participating in swap activities in the United States if the relevant agency determines that regulation of swaps in the foreign country undermines the stability of the U.S. financial system.

In addition, the Act requires the CFTC, SEC, and prudential regulators to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards for the regulation of swaps and regulated swap entities. The Act also requires the CFTC to consult and

coordinate with foreign regulatory authorities on the establishment of consistent international standards for regulation of futures and options on futures.

ADDITIONAL IMPACT ON EXISTING SWAPS

The Act contains an unusual provision that falls under the title of "Legal Certainty." The Act provides that, unless "specifically" reserved in applicable swap documentation, neither the enactment of the Act, nor the application of any requirement under the Act or an amendment made by the Act, will constitute a termination event or similar event that would allow a party to terminate, renegotiate, modify, amend, or supplement transactions under the swap. This provision directly affects the "illegality" termination event provision contained in standard ISDA master agreements, as well as other potential additional termination event provisions that parties may have included in their swap agreements. Without this provision, standard swap documents could potentially be construed as allowing a party to terminate its affected swaps as a result of certain provisions of the Act. Whether this provision will operate to prevent swap transactions from being subject to early termination (and attendant marking to market of terminated transactions, as would generally apply in such circumstances) remains to be seen.

Unfortunately, the Act provides no guidance on determining what types of early termination provisions have been effectively "nullified" by the Act. Absent clarification through the rulemaking process, one possible course of action would be for major market participants, with the assistnce of ISDA, to formulate a voluntary protocol reflecting a market-based consensus on what is meant by "specifically reserved" in order to reduce the degree of economic uncertainty arising from these provisions in the Act.

This provision also seems to contradict other requirements of the Act. For example, it is hard to understand how to reconcile this provision, which could be construed as prohibiting termination resulting from a change in law or illegality, with newly required obligations to post margin not contemplated under the terms of any existing swap or the forced assignment of a swap from a depository institution to a newly created swap entity. There may very well be legal challenges as to the enforceability of this provision of the Act.

TIMING

Unless otherwise provided in the Act, its provisions will be effective 360 days after the date of enactment. This means that the CFTC and SEC must adopt rules imposing minimum capital and initial and variation margin requirements on all uncleared swaps for swap dealers and MSPs within 360 days of the Act's enactment. Generally, the clearing and exchange requirements will also not become effective until 360 days following enactment. Finally, swap dealers and MSPs will be required to register as such with the CFTC or SEC, as applicable, within one year of enactment.

It should be further noted that, to the extent any provision of the Act requires that rules first be written, such provision cannot be effective until at least 60 days after publication of the final implementing regulation. This is important given that most of the provisions of the Act are not self-actuating and require some action by the applicable regulatory agencies before they will become effective.

FINAL THOUGHTS–THE FUTURE IMPACT

Because of the transition periods embedded in the Act, the derivatives world will not change overnight. However, the certainty that many were hoping would come from passage of the Act has not materialized. The extent to which broad, overarching concepts must await the regulatory process to put the necessary "meat on the bones" is unprecedented. For at least the next year (and in some cases, much longer), until somewhat definitive regulatory guidance is provided, it will be difficult for many participants in the OTC derivatives markets to prepare in any significant respect for the new practices, operations, and business conduct requirements that are required by the Act. The uncertainty that will likely continue for at least the next year may create many unintended consequences, including driving derivatives activities to jurisdictions outside of the United States.

Regulators are scrambling to hire additional personnel in order to tackle their massive rule-writing mandate. The period of time that has been given under the Act to the regulators to draft what are likely to be extremely complex rules is very aggressive in light of these complexities. Meeting the rulemaking deadlines imposed by the Act may require a number

of preliminary or interim rules that will have to be polished, revised, and "finalized" over the next several years. The volume of comments alone that regulators are likely to receive following publication of proposed rules will no doubt be massive.

The extent to which the new clearing mandates will decrease systemic risks or simply give rise to new, presently unidentified problems is difficult to assess at this time. The increased potential efficiency and standardization resulting from the clearing process could reduce transaction costs, but such cost savings could be more than offset to the extent that the margin required by clearinghouses is greater than the margin levels participants have historically been required to provide for comparable trades. The additional price transparency arising through the new reporting obligations will undoubtedly reduce spreads. The cost of entering into "bespoke," uncleared swaps will rise due to, among other things, the increased capital and margin requirements that will likely apply to these trades. Although end-users should be able to continue to enter into bespoke, uncleared swaps, if these swaps become uneconomical, end-users may nevertheless be forced to substitute less costly cleared swaps for customized uncleared ones. The consequence may be greater mismatches in the future between the risks that end-users were hoping to hedge through OTC bespoke derivatives and the extent to which the substituted cleared swaps selected effectively hedge those risks. The end-user exemption may prove to be less helpful than many had hoped for. Further, on a system-wide level, it is possible that the centralization of risk in clearinghouses could simply create new "too big to fail" entities that may require government assistance in the event of a future general market disruption.

We discussed above the other ambiguities surrounding the new end-user category of swap participants. Whether end-users will be required to post margin for outstanding uncleared derivatives positions awaits clarification. While the market has closely followed the debate regarding the extent to which the Act purports to retroactively apply its new margin requirements, we must remember that rulemaking guidance is also required for definitively determining which market participants will fall within the end-user "safe harbor" and which of their swaps will be considered swaps entered into for hedging commercial activities. Swap counterparties that are not end-users presently have even less clarity as to (i) whether their preexisting uncleared swaps will retroactively become subject to new margin requirements and (ii) the treatment of such preexisting swaps if such swaps do not contractually contemplate providing such margin or the counterparties under such swaps are not in a position to access the additional capital necessary to meet the new margin requirements.

As we also addressed above, significant uncertainty exists as well as to which derivatives players may become MSPs. The uncertainty is exacerbated by the fact that a market participant can be deemed to be an MSP for one type of derivative but not another. Market participants such as highly leveraged hedge funds that find themselves with an MSP designation may be dramatically affected by the simultaneous need to find additional capital and significantly increase their compliance and business operations. Other vehicles, such as special purpose structured vehicles, may find that they fall within the MSP web with no means to even raise the newly required capital.

The so-called push-out rule, which will require U.S. banks that conduct certain derivatives activities to either spin off those activities or forego having access to certain federal assistance, raises many unanswered questions. The separately capitalized nonbank affiliates required in order to continue certain derivatives activities could be a significant capital drain to the parent banking organization, which would have the opposite effect from its intended purpose—strengthening the financial position of such banks. Presently left unanswered is the nature of the future relationships between such new affiliates and their sponsoring banks. Also unanswered is what happens to outstanding derivatives positions that would need to be transferred to the new affiliates. Finally, lawyers are likely to be the big winners, because bank clients will require ongoing legal advice to navigate the nuances involved in determining which derivative transactions can remain at the bank and which ones must be conducted by the new nonbank affiliates, what types of derivative transactions continue to be permitted, and what types of derivative transactions are outright prohibited.

When regulatory reform was first proposed last year, many market participants hoped that the reform effort would give rise to an opportunity for streamlining the way the U.S. regulates its financial markets by merging together the CFTC and SEC. As the regulatory process moved forward, it became clear that the political will to tackle such an overhaul was lacking. As we have noted, the Act primarily divides the OTC derivatives world between swaps and security-based swaps and the regulatory responsibilities for regulating those derivatives between the CFTC and SEC, respectively. The line between the two types of transactions is quite fuzzy in many cases, to say the least. Such ambiguity as to how certain derivatives are to be characterized and which body is responsible for their regulation will have significant consequences as market participants attempt to comply with the new statutory and regulatory framework. The extent to which the rulemaking process will provide the necessary clarity will depend in part on how well the CFTC and SEC are able to work together in areas of potentially overlapping jurisdiction.

It also cannot be forgotten that, in many circumstances, the SEC and CFTC share their new regulatory responsibilities with one or more federal banking regulatory agencies. While appropriate federal banking regulators have authority over derivatives-related capital and margin requirements for banks and bank holding companies, the bank and nonbank regulators share authority in the case of affiliated swap dealers. The CFTC, SEC, and such banking regulators may all have a role with respect to the derivatives activities of those entities and their compliance with the push-out requirements and the Volcker Rule. The ambiguities as to "who is charged with doing what" among all of these regulatory agencies may bring the market years of turf battles, further complicating the burden of complying with the Act.

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