

## Financial Regulatory Reform Teleseminar Series Follow-Up

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

#### Summary:

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

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

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

Unless otherwise noted below, these provisions take effect on the later of 360 days after the date of enactment (July 16, 2011, as President Obama signed Dodd-Frank Act on July 21, 2010) or, to the extent a rulemaking is required for a specific provision, then it will become effective no less than 60 days after publication of the applicable final rule or regulation.

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

The regulatory architecture of Title VII rests upon the regulation of “swaps” and “security-based swaps,” two new terms defined by the legislation in an extremely broad manner. In common-market parlance, a “swap” is any OTC forward, swap or option on an underlying or reference instrument that is not an individual security or loan, or an index with less than 10 component securities or loans (a “narrow-based security index”). In other words, OTC currency, qualifying index-based credit, commodity and interest rate derivatives are the primary categories of swaps. Conversely, a “security-based swap” is any OTC contract with a reference instrument that is an individual security or loan, a basket of securities or loans, or a narrow-based security index: primary categories of security-based swaps are OTC equity derivatives and credit default swaps on a single security or loan. It is not clear whether an OTC derivative on a basket of certain securities or loans will constitute a swap or a security-based swap under Title VII and, therefore, we expect that this issue will be clarified through the rulemaking process.

Title VII contains a few notable exclusions and exceptions from this broad definition. First, the Treasury Secretary has the authority to exempt foreign exchange (FX) forwards and FX swaps from the regulatory requirements of Title VII (other than reporting and business conduct requirements). This discretionary authority does not apply to OTC FX options—in other words, OTC currency options will be subject to the full regulatory regime of Title VII. Second,

exchange-traded futures and foreign currency options contracts are not swaps. Third, a transaction is not a swap if it involves the sale of a non-financial commodity on a delayed delivery basis, and the parties intended to physically settle the contract at the time they entered into the trade. This exclusion is expected to be interpreted in a manner consistent with the existing forward contract exclusion in the U.S. Commodities Exchange Act.

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

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

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

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

A “major swap participant” is a non-dealer: (1) that maintains a substantial position in any major category of swap (to be defined by regulators), excluding swaps held for hedging or risk mitigation purposes, or maintained by an ERISA plan for hedging or mitigating risks directly associated with the operation of a plan; (2) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (3) that is a highly leveraged financial entity (that is not subject to federal banking regulation) that maintains a substantial position (to be defined by regulators) in outstanding swaps in any major swap category. A “financial entity” consists of any of the following: a swap dealer, a major swap participant, an ERISA plan, a commodity pool, a private investment fund (*i.e.*, a 3(c)(1) or 3(c)(7) fund), or a financial institution. The definition of a major swap participant expressly excludes a captive finance subsidiary; the definition of a major security-based swap participant does not contain such an exclusion.

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

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

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

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

There is a so-called “end-user exemption” from the mandatory clearing requirement, if one of the parties is *not* a financial entity and *is* using the swap to hedge or mitigate commercial risk. A “financial entity” consists of any of the following: a swap dealer, a major swap participant, an ERISA plan, a commodity pool, a private investment fund (*i.e.*, a 3(c)(1) or 3(c)(7) fund), or a financial institution. A party can act as an agent of an affiliated party or an affiliate of that affiliated party and utilize the end-user hedge exemption, so long as neither the principal (nor, if applicable, its affiliate) is a financial entity. To avail itself of the end-user exemption, a party must notify the regulator how it “generally meets its financial obligations in respect of non-cleared swaps.”

Establishes Margin and Capital Requirements for Swaps (sections 731 for swaps; 764(a) for sbs). Each registered swap dealer or major swap participant for which there is a prudential regulator (e.g., a bank) must meet the prudential regulator's (i) minimum "capital requirements" and (ii) minimum "initial and variation margin requirements" on all non-cleared swaps. All non-bank registered swap dealers or major swap participants must meet the requirements of the CFTC or the SEC, as applicable, with respect to (i) minimum capital and (ii) minimum initial and variation margin levels in respect of all non-cleared swaps. These capital and margin requirements are intended to (i) help ensure the safety and soundness of the swap dealer or major swap participant and (ii) be appropriate for the risk associated with non-cleared swaps held by such swap dealer or major swap participant. Margin in the form of non-cash collateral is acceptable, provided that such collateral is consistent with the broader goal of preserving the financial integrity of markets and the stability of the U.S. financial system. The prudential regulators, the CFTC and the SEC are required, to the maximum extent practicable, to maintain comparable minimum capital requirements and minimum initial and variation margin requirements, including the use of non-cash collateral, for swap dealers or major swap participants. The exact levels of margin and capital will be established through the rulemaking process and are not known at this time.

Note that in section 725(c), the margin required by a derivatives clearing organization from each member and participant in respect of cleared swaps "shall be sufficient to cover potential exposures in normal market conditions."

### **Segregation of Margin (section 724 for swaps; 763(d) for sbs)**

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

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

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

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

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

Position Limits: The CFTC or SEC, as applicable, shall establish limits on the amount of positions, "other than bona fide hedge positions," that may be held by any person in order to (i) diminish or eliminate excessive speculation, (ii) deter and prevent market manipulation, (iii) ensure sufficient liquidity for bona fide hedgers, and (iv) ensure price

discovery function is not disrupted. Public Reporting: The CFTC or SEC, as applicable, are authorized to require (i) registered clearing agencies and swap data repositories to make available to the public in real time, swap transaction, volume and pricing data that does not identify the participants, and that specifies criteria for determining block trades and the timing for disclosure of block trades, (ii) parties to a swap (whether cleared or uncleared) to be responsible for reporting swap transactions and pricing information to a registered swap data repository, and (iii) annual and semiannual public reports by the CFTC or SEC of aggregate swap data. Large Swap Trader Reporting: It is generally unlawful for any person to enter into any swap that performs a significant price discovery function in excess of the position limit set by CFTC or SEC, unless such person files the requisite reports with the CFTC or SEC, and keeps books and records of such swaps open to the CFTC and the SEC.

### Prohibition on Federal Assistance to Swap Entity (section 716)

This is the so-called "swap push out" provision, which prohibits a "swaps entity" from receiving any "Federal assistance." A swaps entity means a swap dealer, security-based swap dealer, major swap participant or major security-based swap participant registered as such with the CFTC or SEC, respectively; however, the term excludes an insured depository institution that is a major swap participant or major security-based swap participant. In other words, an insured depository institution will only be treated as a "swaps entity" if it is a swap dealer. "Federal assistance" means the use of any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 13(3)(A), Federal Deposit Insurance Corporation insurance, or guarantees for the purpose of providing support to the swaps entity (regardless of form of support - equity investment, loan, purchase of entity's assets, guarantee, etc.).

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

Section 716 will become effective two years after the effective date of Title VII (*e.g.*, July 16, 2013, based upon the enactment of Dodd-Frank July 21, 2010). An insured depository institution will have an additional two years after section 716 becomes effective (*e.g.*, July 16, 2015) to implement the swap push-out aspects of the provision, subject to rolling one-year extensions to be made by the relevant regulator.

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