

OTC Derivatives Reform: Wall Street Transparency and Accountability Act of 2010

I. Introduction

Title VII of H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), substantially alters the regulation of over-the-counter (“OTC”) derivatives markets. Financial reform, particularly as it relates to derivatives, had the initial purpose of mitigating systemic risk and interconnection concerns in the financial markets. Congress and regulators, nevertheless, are

taking the opportunity in Dodd-Frank to address other perceived issues in the OTC derivatives markets and in the commodities sector.

The effect of OTC derivatives markets reform legislation will be substantial. However, the true reach of the statute will be unknown until the completion of the extensive mandated rulemakings. Congress delegated to the Commodity Futures Trading Commission (the “CFTC”), the Securities and Exchange Commission (the “SEC”) and other regulators the responsibility to fashion many of the material details for implementing the principles contained in Title VII of Dodd-Frank.

commodity swaps, foreign exchange swaps, interest rate swaps, CDS index swaps and equity index swaps.

Dodd-Frank aims to impose similar regulatory requirements on similar instruments. Thus, the CFTC, SEC and other regulators are required under Dodd-Frank to coordinate on portions of the rulemaking required under Title VII. However, the CFTC, SEC and other regulators will only be required to issue joint rules on a small number of definitions.

Title VII of Dodd-Frank also attempts to clarify the relative jurisdictions of the CFTC and the Federal Energy Regulatory Commission (“FERC”) over energy markets. The CFTC and FERC are required to enter into a memorandum of understanding regarding their respective jurisdiction over energy markets. In addition, the CFTC is permitted to exempt contracts entered into pursuant to a FERC or state agency tariff or rate schedule from CFTC oversight as Swaps.

What every firm using derivatives must do today:

- 1) Determine whether any of the derivatives they enter into are Swaps;
- 2) Determine if they are a Swap Dealer or Major Swap Participant;
- 3) Determine if their Swaps must be centrally cleared or traded on an exchange;
- 4) Determine what Swaps they must report; and
- 5) Determine whether or not they or their counterparty must provide margin or meet capital requirements.

II. Jurisdiction

Dodd-Frank maintains the jurisdictional separation between the CFTC and SEC reached in the Shad-Johnson Accord. The SEC will have jurisdiction over markets for Security-Based Swaps, and the CFTC will have jurisdiction over markets for non-security based Swaps. In practice, the SEC will have jurisdiction over a portion of the equity swap market and a portion of the credit default swap (“CDS”) market. The CFTC will have jurisdiction over the remainder of the OTC swaps markets, including the markets for

III. Swaps and Security-Based Swaps

Dodd-Frank grants the CFTC the authority to regulate OTC Swaps markets. The definition of “Swap” encompasses a wide array of

instruments. The definition captures nearly all derivatives except for futures, forwards intended to be physically-settled, foreign exchange and currency derivatives that are not centrally cleared or not exchange traded (if the Secretary of the Treasury chooses to carve out such instruments from the definition of Swap).

Under Dodd-Frank, the SEC has jurisdiction over Security-Based Swaps markets. A “Security-Based Swap” is based on a single security or loan or a narrow-based security index. A narrow-based security index is an index of securities that meets one of the following four requirements: (i) it has nine or fewer components; (ii) one component comprises more than 30 percent of the index weighting; (iii) the five highest-weighted components comprise more than 60 percent of the index weighting; or (iv) the lowest-weighted components, comprising in the aggregate 25 percent of the index’s weighting, have an aggregate dollar value of average daily volume over a six-month period of less than \$50 million (\$30 million if there are at least 15 component securities).

IV. Swap Dealers and Major Swap Participants

Dodd-Frank imposes most of its regulatory and prudential requirements on two classes of entities: Swap Dealers and Security-based Swap Dealers (together, “Swap Dealers”), and Major Swap Participants and Major Security-based Swap Participants (together, “Major Swap Participants”).

A Swap Dealer is any person who (i) holds themselves out as a dealer in Swaps, (ii) makes a market in Swaps, (iii) regularly enters into Swaps with

counterparties as an ordinary course of business for its own account, or (iv) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in Swaps. An entity can be designated a Swap Dealer for one class of Swaps or for multiple classes of Swaps.

If the third prong of this definition is applied literally, then many frequent users of Swaps could be deemed Swap Dealers including commercial end users who use derivatives primarily for hedging. However, a *de minimis* exception was added to the definition of Swap Dealer during conference, which should partially mitigate this potential issue. Also, a bank cannot be deemed a Swap Dealer solely because it enters into Swaps with customers in connection with the origination of loans.

A Major Swap Participant is any person (i) who is not a Swap Dealer, (ii) who maintains a substantial position (as defined by the CFTC and SEC) in Swaps, excluding positions held for hedging commercial risk and hedge positions maintained by employment benefit plans, (iii) whose outstanding Swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States financial markets, or (iv) who is a highly leveraged financial entity not subject to a federal banking regulator’s capital requirements that maintains a substantial position in outstanding Swaps. An entity can be designated a Major Swap Participant for one class of Swaps or for multiple classes of Swaps. Financing subsidiaries that facilitate the purchase or lease of goods manufactured by their

parent and use Swaps to hedge the risk associated with that financing are excluded from the definition of Major Swap Participant.

V. Mandatory Central Clearing

Under Dodd-Frank, both Swap Dealers and Major Swap Participants will be required to clear most or all of their standardized Swaps with a central counterparty.

The determination of which Swaps will be subject to mandatory clearing will be made by the CFTC and SEC for their respective jurisdictions. Derivatives clearing organizations and clearing agencies (together, “Clearing Houses”) will be required to submit all new Swaps that they would seek to accept for clearing to their respective regulators for approval. The appropriate regulator will determine if the Swap will be subject to mandatory clearing. The CFTC and SEC can subject an existing class of Swaps to the mandatory clearing requirement at their own discretion. However, any Swap in existence before the enactment of Dodd-Frank will not be subject to mandatory clearing.

There is an exemption from the mandatory clearing requirement for derivatives end users. If a Swap is subject to the mandatory clearing requirement, but one of the parties to the Swap (i) is not a Financial Entity (defined below), (ii) that party entered into the Swap to hedge or mitigate commercial risk, and (iii) that party informed the CFTC or SEC how it meets its financial obligations associated with uncleared Swaps, then that party may elect to not clear the Swap or may elect to clear the Swap at a Clearing House of its

choice. To utilize this exemption, a publicly traded company must first receive approval from an appropriate committee of its board of directors.

A Financial Entity is either a (i) a Swap Dealer or Major Swap Participant, (ii) a commodity pool or private fund, (iii) an employee benefit plan, or (iv) a person predominantly engaged in activities that are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956. Financing subsidiaries that facilitate the purchase or lease of goods manufactured by their parent and use Swaps to hedge the risk associated with that financing are excluded from the definition of “financial entity.” In addition, the CFTC and SEC have the authority to exclude small banks and credit unions from the definition of “financial entity.”

VI. Exchange Trading

Under Dodd-Frank, counterparties will be required to execute most or all of their standardized Swaps on designated contract markets in the case of Swaps, securities exchanges in the case of Security-Based Swaps, or Swap Execution Facilities¹ (collectively, “Exchanges”).

There are two exemptions from mandatory exchange trading: (i) a Swap is not required to be executed on an Exchange if no Exchange will list the Swap for trading; and (ii) a Swap is not required to be executed

¹ A Swap Execution Facility is a facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants. As currently drafted, a Swap Execution Facility would encompass both electronic trading platforms as well as voice brokerage facilities.

on an Exchange if a party to the Swap is using the clearing exemption.

VII. Reporting

Dodd-Frank requires all uncleared Swaps to be reported directly to a Swap Data Repository, or if no Swap Data Repository will accept the Swap, the appropriate regulator. If one counterparty to a Swap is a Swap Dealer, then the Swap Dealer is obligated to report the Swap. If a Major Swap Participant enters into a Swap with a party that is neither a Swap Dealer nor Major Swap Participant, then the Major Swap Participant is required to report the Swap. If both counterparties to a Swap are Swap Dealers or if both counterparties are neither a Swap Dealer nor Major Swap Participant, then the counterparties may select which counterparty is responsible for reporting the Swap.

In addition, Dodd-Frank requires that all uncleared Swaps existing prior to enactment be reported to a Swap Data Repository or, if no Swap Data Repository will accept the Swap, the appropriate regulator, within 120 days of enactment of Dodd-Frank.

VIII. Capital and Margin Requirements

Both Swap Dealers and Major Swap Participants will be subject to new prudential capital requirements. If the Swap Dealer or Major Swap Participant is a bank, the capital requirements will be set by its prudential banking regulator. The CFTC and SEC will set capital requirements for non-bank Swap Dealers and non-bank Major Swap Participants under their respective jurisdictions. When setting capital requirements, the regulators

may take into account all of an entity’s Swap positions, new and existing, regardless of whether the entity is designated a Swap Dealer or Major Swap Participant for a single type of Swap, as well as all other activity that may not be subject to regulation under Title VII of Dodd-Frank.

Swap Dealers and Major Swap Participants will also be subject to new initial and variation margin requirements on uncleared Swaps. If the Swap Dealer or Major Swap Participant is a bank, the margin requirements will be set by its prudential banking regulator. The CFTC and SEC will set margin requirements for all non-bank Swap Dealers and non-bank Major Swap Participants under their respective jurisdictions. Regulators may permit the use of non-cash collateral to satisfy margin requirements as long as it does not pose a systemic risk.

There is no exemption from Title VII’s capital and margin requirements. Previous drafts of the bill contained an explicit exemption from the mandatory margin requirements for certain transactions involving end users. However, that exemption was removed during the conference process. While the current margin requirements apply exclusively to Swap Dealers and Major Swap Participants, many end users worry that because of the margin requirements Swap Dealers will either price their cost incurred because of the margin requirement into the Swap or will require their counterparties to post margin as well. In response to these concerns, chairmen Dodd and Lincoln wrote a letter clarifying that Title VII’s margin requirement was not intended to impose costs

and requirements on derivatives end users and urged regulators to consider the potential cost to end users when drafting the implementing rules. Many market participants expect the CFTC and SEC to clarify when margin requirements apply to Swaps in which one counterparty is an end user.

Dodd-Frank also allows regulators to impose Title VII's margin requirements on Swap Dealers' or Major Swap Participants' existing Swaps. However, Title VII contains legal certainty language that should prevent Swap Dealers and Major Swap Participants from requiring their end user counterparties to post margin on existing Swaps or terminating such Swaps on the basis of a change in law (unless the Swap contract contains an explicit provision addressing derivatives reform).

IX. Position Limits

Dodd-Frank requires the CFTC to implement aggregate position limits for all contracts based on the same underlying commodity. The position limits would apply to an entity's positions on designated contract markets, on Swap Execution Facilities, in OTC significant price discovery contracts and, in certain cases, on foreign boards of trade. The CFTC must also put in place exemptions from the position limits for positions that are *bona fide* hedges. The federal aggregate position limits are in addition to any position limits imposed by individual exchanges, and apply to an entity's aggregate positions across markets.

Under Dodd-Frank, the SEC is authorized, but not required, to adopt position limits for Security-Based Swaps. When applying position

limits, the SEC must aggregate an entity's position in Security-Based Swaps with its position in the underlying security. The SEC is also authorized to take Security-Based Swaps into account when determining if an entity is required to report under the Securities Exchange Act's beneficial ownership reporting requirements in Sections 13 and 16.

X. Segregation of Collateral

Under Dodd-Frank, any initial margin proffered in connection with a centrally cleared Swap must be treated as belonging to the customer. In the case of an uncleared Swap (but not Security-Based Swap), a Swap Dealer or Major Swap Participant must notify its counterparty of its right to require the segregation of any initial margin with an independent third-party custodian. If the counterparty does not elect to segregate its initial margin, then the Swap Dealer or Major Swap Participant must submit quarterly reports to the counterparty on the status of the initial margin. Variation margin provided for uncleared Swaps is not subject to a segregation requirement under Dodd-Frank.

XI. Business Conduct Standards

Dodd-Frank authorizes the CFTC and SEC to impose a substantial number of business conduct and compliance requirements on Swap Dealers and Major Swap Participants. However, the CFTC and the SEC cannot impose prudential requirements on an entity that is already subject to prudential regulation by another regulator. Below is a summary of the major business conduct requirements imposed by Dodd-Frank.

Registration

Swap Dealers and Major Swap Participants must register with the CFTC and/or SEC as appropriate. After registering with their respective regulator, Swap Dealers and Major Swap Participants will be required to submit reports to that regulator in a form and at a frequency to be determined by the regulator. A Swap Dealer or Major Swap Participant will be required to disclose to the CFTC or the SEC information on (i) the terms and conditions of its Swaps, (ii) its Swap trading operations, and (iii) its financial integrity protections.

Record Keeping

Swap Dealers and Major Swap Participants must maintain daily trading records and all related documents for all Swaps, including all recorded phone conversations, emails, and instant messages. In addition, Swap Dealers and Major Swap Participants will be required to maintain daily trading records for each counterparty in a manner that is identifiable with each transaction. Finally, each Swap Dealer and Major Swap Participant is responsible for maintaining a complete audit trail for conducting comprehensive trade reconstructions. All records will be required to be maintained for a period of time to be determined by the respective regulator.

Compliance Requirements and Disclosures

A Swap Dealer or Major Swap Participant will be required to conform with business conduct standards prescribed by its respective regulator. The standards will require processes to (i) prevent fraud, manipulation, and other abusive

practices; (ii) ensure diligent supervision of operations; and (iii) ensure compliance with position limits.

Swap Dealers and Major Swap Participants will be required to disclose to a counterparty that is not a Swap Dealer or Major Swap Participant (i) the material risks and characteristics of a Swap; (ii) the source and amount of any compensation; (iii) any material incentives or conflicts of interest; (iv) for cleared Swaps, at the request of the counterparty, the clearing house's daily mark; and (v) for uncleared Swaps, the daily mark of the Swap Dealer or Major Swap Participant. The disclosures must be made in good faith and in a fair and balanced manner.

Special Entities and Standards of Care

Swap Dealers and Major Swap Participants who engage in transactions with Special Entities are subject to additional business conduct standards for those transactions. Special Entities are government agencies, municipalities, certain employee benefit plans and endowments.

When a Swap Dealer or Major Swap Participant acts as an adviser to a Special Entity, they have a duty to act in the best interest of the Special Entity and are required to make reasonable efforts to obtain information necessary to determine if a Swap is in the best interest of the Special Entity. In addition, Swap Dealers and Major Swap Participants that enter into a Swap with a Special Entity that is a government agency or municipality counterparty must have a reasonable basis to believe that the Special Entity has an independent adviser that, among other things, (i) has sufficient knowledge to evaluate the transaction; (ii) is independent from the Swap Dealer or Major Swap Participant; (iii) is acting in the counterparty's best interest; and (iv) will provide written representations regarding fair pricing and the appropriateness of the transaction.

XII. Effective Date

Most provisions of Dodd-Frank become effective one year after its enactment. Many of the implementing rules to be promulgated by the CFTC, SEC and other federal regulators

are to become effective at the same time. The notable exception is reporting of existing Swaps that are not centrally cleared. The CFTC and SEC are expected to publish criteria for such reporting within 90-days of the enactment of Dodd-Frank, with reporting to begin 30-days thereafter.

XIII. Conclusion

Dodd-Frank introduces material changes to the OTC derivatives markets. Many of the specific requirements imposed by Dodd-Frank will depend on the final rules adopted by the CFTC and SEC. The year following enactment of Dodd-Frank will see tremendous activity by such federal regulators. Thus, the full impact of Dodd-Frank is yet to be seen. Companies that use OTC derivatives should undergo a thorough compliance review to determine the extent to which they or the derivatives contracts they enter into fall within the new regulatory regime.

If you have any questions about these matters, please contact [David McIndoe](#), [Michael Sweeney](#) or your Hunton & Williams LLP contact.

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