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Reform of the Swaps Market under the Dodd-Frank Act

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On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") into law. Title VII of the Act, titled "Wall Street Transparency and Accountability Act of 2010" ("Title VII"), provides for new federal regulation of the swaps market and gives the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC", together with the CFTC, the "Commissions") broad authority to regulate the market and its principal participants. Unless otherwise provided, Title VII becomes effective on the later of (i) July 16, 2011[1] and (ii) if rulemaking is required, 60 days after the publication of the final rule or regulation.

This legislation seeks to make fundamental changes in the way the "swaps market" operates. While most of the provisions of the Act are directed at "swap dealers" and "major swap participants" (each defined below), the results of those changes will affect all companies that use swaps to hedge exposures in their businesses. The Act seeks to reduce systemic risk, increase transparency and improve efficiency in the swaps market. At the same time, because of the sweeping nature of the changes to be made, as well as the need for clarifying and implementing regulations and/or technical corrections, it remains to be seen how effectively the "new" swaps market will function, whether it will offer cost-effective hedges for the wide range of risks that are hedged today, how the new regulations will impact "end users" and whether the U.S. swaps market will be competitive with similar markets based in other countries.

SUMMARY OF KEY CHANGES TO THE SWAPS MARKET

To a large extent, the Act looks to the exchange-traded futures market as the model for the regulatory scheme for the "new" swaps market. An important difference is that the Act would allow an over-the-counter market in non-standardized swaps to continue to exist, but subject to margin, capital and reporting requirements. While these changes may improve price transparency and overall market efficiency, they may also make swaps more costly for end users.

- **Centralized Clearing and Margining** — Today, the swaps market is largely conducted on the basis of individually negotiated bilateral contracts, individual credit assessments and individually negotiated credit support. Under Title VII, whenever persons other than end users enter into swaps with each other, they will generally be required to place those swaps through a central clearinghouse and support the exposure of those swaps with cash or other acceptable margin that varies daily based on changes in the mark-to-market exposure of those swaps. This is intended to address the perceived systemic risk of a potential default by a swap dealer or major swap participant. For swaps between these participants that are not sufficiently standardized to be accepted by a clearinghouse, the Act will not require central clearing but will require margin to be posted as well as significant capital to be maintained by the swap dealer or major swap participant, as noted below.
  - The Act's clearing and margin requirements are intended to convert the inter-dealer market in standardized swaps from one that is based on individual credit assessments and collateral negotiations to one that is based on centrally-cleared positions that are fully collateralized by cash or other acceptable margin.

[1] This date is 360 days after the date of the Act's enactment, which is July 21, 2010.

- While the Act is not intended to require margin from end users,[2] it may nevertheless have that effect, to the extent that dealers elect to "pass through" the requirements for margin to their customers. In addition, end users will generally be permitted to require that their swaps be submitted for clearing and as a result voluntarily accept clearinghouse margin requirements.

- **Trading and Reporting** — Today, swaps are not exchange traded and the reporting of swap prices is based largely on informal dealer surveys or internal dealer databases. End users seeking to enter into swaps usually obtain quotes from several dealers before negotiating definitive transaction terms with a single dealer and can only terminate a swap through a negotiation with their original dealer counterparty. Dealers offset these positions in a variety of ways, including by entry into swaps with other dealers. The Act will generally require standardized swaps between dealers and/or major swap participants to be executed through an exchange or trading facility and in other cases require the swap prices to be centrally reported. The intended effects of these requirements, together with the central clearing requirements, are (i) increased transparency in the pricing of swaps and (ii) increased liquidity to the extent a true "trading" market develops in standardized swaps.

  - Increased transparency of pricing through real-time reporting requirements may increase price competition and reduce the spread between bids and offers for all participants in the swaps market.

  - The ability to "close out" a standardized swap that is exchange traded and centrally cleared through an offsetting transaction should facilitate the ability of end users to terminate transactions without having to negotiate individual terminations with original counterparties. It may also increase use of standardized swaps, even if they provide less "complete" hedges than individually tailored swaps.

  - A true "trading" market will require standardized contracts; the use of standardized contract terms may increase, while the use of individually tailored swaps that are not exchange traded or centrally cleared may decrease.

- **Capital, Conduct and Other Regulation** — Today, there is no single system of regulation for the swaps market in the United States. Under the Act, the Commissions would, together with the banking regulators, be charged with creating a harmonized system of regulation that would include, among other things, registration requirements for swap dealers and major swap participants, requirements for capital to support the business, business conduct standards and various recordkeeping and reporting requirements.

The remainder of this memorandum provides a brief overview of the key provisions of Title VII and further discusses Title VII's implications for end users.

OVERVIEW OF KEY PROVISIONS OF TITLE VII

Regulatory Authority of the CFTC and the SEC

The Act gives the CFTC regulatory authority over swaps (which, as defined below, includes a broad array of derivatives transactions), swap dealers and major swap participants and the SEC regulatory authority over security-based swaps, security-based swap dealers and major security-based swap participants (each defined below). Title VII requires that all swap dealers and major swap participants register with the CFTC and all security-based swap dealers and major security-based swap participants register with the SEC.[3] In addition, Title VII allows the Commissions, in consultation with the Secretary of Treasury, to ban foreign entities from participating in U.S. swap-based activities if the regulation of the foreign swaps market undermines the stability of the U.S. financial system.

Title VII requires that the Commissions promulgate rules for the implementation of the Act no later than July 16, 2011. The Commissions are required to consult each other and coordinate their rulemaking, to the extent possible, in order to ensure regulatory consistency and comparability. Title VII also allows both the CFTC and the SEC to challenge each other's rulemaking in the U.S. Court of Appeals for the District of Columbia Circuit.

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[2] For a discussion of the treatment of end users under Title VII, see the section titled "Implications for 'End Users' — Application of Clearing, Exchange Trading and Margin Requirements".

[3] Throughout the remainder of this memorandum, with the exception of the section titled "Definitions", "swaps" and "security-based swaps" will collectively be referred to as "swaps", "swap dealers" and "security-based swap dealers" will collectively be referred to as "swap dealers" and "major swap participants" and "major security-based swap participants" will collectively be referred to as "major swap participants".

Centralized Clearing and Trading Requirements

Title VII requires swap transactions to be cleared through a regulated clearinghouse if both a clearinghouse will accept the swaps for clearing and the Commissions require that the swaps be cleared. Title VII also requires swap transactions that are subject to mandatory clearing to be traded on an exchange or swap execution facility unless no such centralized market exists. Moreover, only "eligible contract participants" (as defined below) may enter into a swap that is not traded on an exchange. Swaps that are not accepted for clearing by a clearinghouse must be reported to a swap data repository or, if there is no swap data repository that will accept the swap, to the relevant Commission. Importantly, Title VII provides for an exemption to the clearing and exchange trading requirements in cases where one of the counterparties to the swap (i) is not a financial entity,[4] (ii) is using swaps to hedge or mitigate commercial risk and (iii) notifies the relevant Commission, in a manner to be determined, that it meets the financial obligations of entering into a non-cleared swap transaction. This exemption is often referred to as the "end user exemption" and is discussed in more detail below.[5] Also, in the case of companies that are "reporting companies" under the Exchange Act, the decision to enter into swaps that are subject to exemptions from the clearing and exchange trading requirements must be reviewed and approved by an "appropriate" committee of the board of directors.

Swaps that are entered into on or after July 21, 2010 but before the effective date of Title VII's clearing requirements must be reported to a registered swap data depository or the relevant Commission no later than 90 days after such effective date (or at such other time as determined by the Commissions). Swaps entered into before July 21, 2010 are exempt from the clearing requirements if they are reported to a registered swap data depository or the relevant Commission no later than 180 days after the effective date of Title VII's clearing requirements. In addition, Title VII requires that unexpired, non-cleared swaps entered into before July 21, 2010 be reported to a swap data repository or the relevant Commission no later than 30 days, or such other period determined by the Commissions, after the issuance of the interim final rule regarding the reporting of such swaps, which must take place by October 19, 2010, which is 90 days after the Act's enactment.

Title VII authorizes and requires the Commissions to make swap transaction and pricing data publicly available. With respect to swaps that are cleared at a registered clearinghouse, the Commissions must promulgate rules that require real-time public reporting. With respect to swaps that are not subject to the mandatory clearing requirement and are reported to a swap data repository or the relevant Commission, the Commissions must promulgate rules that require real-time public reporting in such a manner that does not disclose the business transactions and market positions of any person.

Margin Requirements

The Commissions and the prudential regulators (which include the Federal Reserve) are required to impose both initial and variation margin requirements on swap dealers and major swap participants. Title VII requires margin rules for all swaps that are not cleared, as well as margin requirements and public disclosure of the clearinghouses' margin-setting methodologies for swaps that are cleared. The Act could be interpreted as applying margin requirements to all non-cleared swaps entered into by end users, but as further discussed below, Congress intended to exclude end users from the explicit statutory margin requirement. Title VII allows the Commission and the prudential regulators to permit the use of non-cash collateral to fulfill margin requirements but it does not further specify the types of non-cash collateral that would be allowed.

Capital Requirements

The Commissions and the prudential regulators are required to impose capital requirements on swap dealers and major swap participants. When setting the capital requirements, the prudential regulators and the Commissions must take into account the risks associated with both the type of swaps and the unregulated activities of the swap dealer or major swap participant.

Recordkeeping and Reporting Requirements

Under Title VII, each swap dealer and major swap participant must maintain daily records of its swaps as well as all related records and recorded communications (including electronic mail, instant messages and recordings of telephone calls). In addition, each swap dealer and major swap participant must maintain a complete audit trail for conducting comprehensive and accurate trade reconstructions.

"Swap Push-Out Rule"

Section 716 of the Act (the "Swap Push-Out Rule") prohibits "Federal assistance" to "swap entities", which are generally defined as any registered swap dealer or major swap participant (excluding any major swap participant that is an insured

[4] For purposes of this exemption, Title VII defines "financial entity" as a swap dealer, major swap participant, commodity pool, private fund (as defined in the Investment Advisers Act of 1940), an employee benefit plan (as defined in the Employee Retirement Income Security Act of 1974) or a person predominately engaged in activities that are in the business of banking or financial in nature (as defined in the Bank Holding Company Act of 1956).

[5] The version of the Act that was passed by the Senate on May 20, 2010 (the "Senate Bill") contained a broader "commercial end user" exemption. For additional discussion, see the section titled "Implications for 'End Users' — Application of Clearing, Exchange Trading and Margin Requirements".

depository institution). The prohibition does not apply to, and will not prevent insured depository institutions from having, an affiliate of an insured depository institution that is a swap entity if certain requirements are met.[6] Additionally, the prohibition will not apply to insured depository institutions if the institution's swap activities are limited to (i) hedging and other similar, risk mitigating activities or (ii) swaps that involve rates or references assets in which national banks are permitted to invest (excluding non-cleared credit default swaps). As a result of this exception, many of that swap transactions that swap entities currently engage in, such as interest rate swaps and currency swaps, will be unaffected by the Swap Push Out Rule. The Swap Push-Out Rule will be effective on July 22, 2012.[7] In addition, the Swap Push-Out Rule allows for a two-year transition period for insured depository institutions, as well as the possibility of a discretionary extension for up to one year.

Business Conduct Standards

Title VII requires the Commissions to adopt codes of conduct for swap dealers and major swap participants, which must include a duty to (i) prove that the counterparties meet the definition of eligible contract participant and (ii) "communicate in a fair and balanced manner based on principles of fair dealing and good faith", among others. In addition, under Title VII, a swap dealer or major swap participant that is acting as an advisor to a "special entity" (defined to include federal and state agencies and private and government pension plans) regarding a swap transaction will have a duty to act in the special entity's best interests.

Beneficial Ownership Reporting; Short-Swing Profits

Title VII amends Sections 13 and 16 of the Securities and Exchange Act of 1934, as amended (the "Exchange Act") to establish that persons will be deemed to have acquired beneficial ownership of an equity security as the result of the purchase or sale of a security-based swap only if the SEC, by rule and in consultation with the prudential regulators and the Secretary of Treasury, determines that (i) such purchase and sale "provides incidents of ownership comparable to direct ownership of the equity security" and (ii) such determination is necessary to achieve the purposes of the relevant sections of Title VII. Title VII also amends Sections 13(d), 13(f) and 13(g) of the Exchange Act to require reporting of beneficial ownership positions created by security-based swaps to the extent provided in the SEC rules. Moreover, Title VII expands the definitions of "purchase" and "sale" under the Exchange Act and the Securities Act of 1933, as amended (the "Securities Act"),[8] which has implications for when a security-based swap will trigger the registration requirements of the Securities Act as well as the beneficial ownership reporting and short-swing profit rules of the Exchange Act.

IMPLICATIONS FOR "END USERS"

Many companies today use swap transactions for the purpose of hedging and mitigating a wide range of risks in the company's business, either through a parent company or one or more subsidiaries. Some companies use financing subsidiaries to act as a central swap entity for all affiliate companies. The effects of Title VII on end users are discussed below.

Exclusion from Swap Dealer and Major Swap Participant Definitions

Title VII's definitions for swap dealers and major swap participants are not intended to capture end users. Accordingly, end users should remain outside the registration, capital, recordkeeping and other requirements that will be imposed by the Commissions on swap dealers and major swap participants. End users are not intended to be treated as swap dealers because they do not (i) hold themselves out as dealers in swaps, (ii) make a market in swaps, (iii) regularly enter into swaps with counterparties for their own account in the ordinary course of business or (iv) engage in activity that causes the end users to be commonly known in the trade as dealers or market makers in swaps. Moreover, the Act explicitly excludes from the swap dealer definition any person who enters into swaps outside of its regular business and for its own account, either individually or in a fiduciary capacity. Title VII's major swap participant definition is also intended not to apply to end users on the basis that end users maintain swap positions for the purpose of hedging or mitigating commercial risk, including the risks of affiliated companies. In a letter written on June 30, 2010 by Senator Christopher Dodd and Senator Blanche Lincoln to Representative Barney Frank and Representative Collin Peterson (the "June 30 Letter"), Senators Dodd and Lincoln explained that the scope of the definitions of swap dealer and major swap participant were purposely narrow in order to avoid capturing end users in the definitions. However, where companies run separate trading operations as an adjunct to their core businesses, they should

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6 Such requirements consist of the following: (i) the institution is part of a bank holding company or savings and loan holding company that is supervised by the Federal Reserve and (ii) the swap entity affiliate is subject to sections 23A and 23B of the Federal Reserve Act (and other requirements determined by the Commissions and the Board of Governors of the Federal Reserve System (the "Board of Governors")).

7 This date is two years after the date on which the Act became effective, which is July 22, 2010.

8 The definitions of the terms "purchase" and "sale" now include "the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap, as the context may require".

consider whether they may fall under one of these definitions with respect to portions of those operations because of the nature and extent of their trading operations.

Application of Clearing, Exchange Trading and Margin Requirements

Title VII contains a broad requirement for the clearing and exchange trading of swaps, so long as a clearinghouse will accept the swap for clearing and an exchange or trade execution facility will accept the swap. This requirement applies to all "persons" other than entities that (i) are not a financial entity, (ii) are using swaps to hedge or mitigate commercial risk and (iii) notify the relevant Commission, in a manner to be determined, that they meet the financial obligations of entering into a non-cleared swap transaction. While it is not clear how the "notification" requirement in clause (iii) of the end user exemption will be implemented, the intent of this section is to exempt end users from the clearing and exchange trading requirements.[9] Moreover, it is not clear how significant the differences are between (i) the group of the entities that falls outside of the swap and major swap participant definitions and (ii) the group of entities that complies with the end user exemption set out above. Over time, it may be that these two groups will be viewed as being comprised of the same entities.

As described above, for end users that are reporting companies under the Exchange Act, the decision to enter into swaps that are subject to exemptions from the clearing and exchange trading requirements must be reviewed and approved by an appropriate committee of the board of directors. In addition, Title VII requires all swaps that are not cleared to be reported to a swap data repository or, if there is no swap data repository that will accept the swap, to the relevant Commission. End users will be required to comply with this reporting requirement. Moreover, swaps that are not subject to the mandatory clearing requirement will still be subject to real-time public reporting requirements, which will be done in such a manner that does not disclose the business transactions and market positions of any person.

Under Title VII, the Commissions will be required to implement margin requirements that will be applicable to all swaps that are not cleared. The Senate version of the Act contained a provision that explicitly excluded end users from the margin requirements.[10] As noted above, it is possible that Title VII, as enacted, could be interpreted as imposing margin requirements on all parties to non-cleared swap transactions, including end users. However, in response to criticism of this apparent error, Senators Dodd and Lincoln wrote the June 30 Letter to state that Congress did not intend to subject end users to margin requirements. While the June 30 Letter does not have the force of law or even formal legislative history, it may inform the rulemaking process and provide a preview of clarifications that might appear in a technical corrections bill.

Importantly, regardless of whether end users are exempt from the explicit margin requirements for non-cleared swaps, the Act's imposition of cash margin and significant capital requirements on swap dealers and major swap participants for both cleared and non-cleared swaps could result in swap dealers and major swap participants "passing through" the extra costs to their customers, the end users, in the form of pricing, margin requirements or both. In addition, end users are permitted to voluntarily require that their swaps be submitted for clearing and voluntarily accept clearinghouse margining requirements as a result. Thus the Act's margin requirements may ultimately affect end users, regardless of the content of implementing regulations, a corrections bill and Congressional intent.

DEFINITIONS

Section 721 broadly defines "swaps" as any agreement, contract or transaction that (i) is a put, call, cap or similar option of any kind, (ii) provides for any purchase, sale, payment or delivery that is dependent on the occurrence or non-occurrence of any event related to a potential financial, economic or commercial consequence (excluding dividends on an equity security), (iii) is an instrument commonly know as an interest rate swap, foreign exchange swap, basis swap or credit default swap, among others, (iv) are commonly known to the trade as a swap, (v) meets the definition of "swap agreement" as defined in Section 206A of the Gramm-Leach-Bliley Act[11] or (vi) is any combination or permutation of items (i) – (v). Section 761 defines

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[9] Notably, the Senate Bill included a broader "commercial end user exemption" that exempted companies from the clearing requirement if the commercial end user was using the swap to hedge its own commercial risk. "Commercial end user" was defined as "any person other than a financial entity . . . who, as its primary business activity, owns, uses, produces, processes, manufactures, distributes, merchandises, or markets goods, services, or commodities (which shall include but not be limited to coal, natural gas, electricity, ethanol, crude oil, gasoline, propane, distillates, and other hydrocarbons) either individually or in a fiduciary capacity".

[10] The Senate Bill contained a provision that stated that the margin requirements for non-cleared swaps would not be applicable to swaps in which one of the counterparties is not a (i) swap dealer, (ii) major swap participant or (iii) financial entity, "and such counterparty is eligible for and utilizing the commercial end user clearing exemption".

[11] The Gramm-Leach-Bliley Act was enacted in 1999 and it eliminated legal barriers to affiliations among banks, securities firms, insurance companies and other financial service companies. Section 206A of the Gramm-Leach-Bliley Act defines "swap agreements" as "any individually negotiated contract, agreement, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets, but does not include any other identified banking product".

"security-based swaps" as a swap (as defined in Section 721) that is based on a narrow-based security index, single security or loan, or the occurrence or non-occurrence of an event relating to the issuer of a security on a narrow-based security index.[12]

Section 721 defines "swap dealers" as any person who (i) holds itself out as a dealer in swaps, (ii) makes a market in swaps, (iii) regularly enters into swaps with counterparties for its own account in the ordinary course of business or (iv) engages in activity that causes the person to be commonly known in the trade as a dealer or market maker in swaps. Similarly, Section 761 defines "security-based swap dealers" as any person who (i) holds itself out as a dealer in security-based swaps, (ii) makes a market in security-based swaps, (iii) regularly enters into security-based swaps with counterparties for its own account in the ordinary course of business or (iv) engages in activity that causes the person to be commonly known in the trade as a dealer or market maker in security-based swaps.

Section 721 defines "major swap participants" as any person who is not a swap dealer and (i) maintains a substantial position in swaps (excluding positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (as defined in the Employee Retirement Income Security Act of 1974) for the primary purpose of hedging or mitigating risk associated with the plan), (ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the U.S. financial markets or banking system or (iii) is a financial entity that maintains a substantial position in outstanding swaps, is highly leveraged and is not subject to the capital requirements of a Federal banking agency. Similarly, Section 761 defines "major security-based swap participants" as any person who is not a security-based swap dealer and (i) maintains a substantial position in security-based swaps (excluding positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (as defined in the Employee Retirement Income Security Act of 1974) for the primary purpose of hedging or mitigating risk associated with the plan), (ii) whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the U.S. financial markets or banking system or (iii) is a financial entity that maintains a substantial position in outstanding security-based swaps, is highly leveraged and is not subject to the capital requirements of a Federal banking agency. Notably, both of these definitions and their resulting applicability to a given entity will be further clarified after the Commissions have implemented relevant regulations.

Lastly, Section 721 raises the standard for two categories in the definition of "eligible contract participant".[13] First, the new definition requires that government entities, multinational or supranational government entities and any instrumentality, agency or department of such government entities own or invest in at least $50 million of investments on a discretionary basis. (Before the enactment of Title VII, the entities were required to own or investment in at least $25 million of investments on a discretionary basis.) Second, the new definition requires individuals to invest in at least (i) $10 million of investments on a discretionary basis or (ii) $5 million of investments on a discretionary basis if the individual is entering into the contract for the purpose of managing the risks of the individual's assets or liabilities. (Before the enactment of Title VII, individuals were required to have total assets in excess of $10 million or $5 million if the individual was entering into the contract for the purpose of managing the risks of the individual's assets or liabilities.)

Notably, Title VII grants the Commissions authority to further define each of these terms, in consultation with the Board of Governors, if both entities deem that such action is "in the public interest, and for the protection of investors". Therefore, these definitions are subject to change.

This memorandum relates to general information only and does not constitute legal advice. Facts and circumstances vary. We make no undertaking to advise recipients of any legal changes or developments.

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[12] Title VII prohibits state laws from regulating "swaps" and "security-based swaps" as insurance contracts. Moreover, Title VII excludes identified banking products from regulation by the CFTC and provisions of the Commodity Exchange Act. Title VII also explicitly excludes identified banking products from the definition of "security-based swap". However, this exclusion does not apply to an identified banking product that (i) is a product of a bank that is not under a Federal banking agency's regulatory jurisdiction, (ii) meets the definition of "swap" or "security-based swap" as defined in the Commodity Exchange Act and the Exchange Act, respectively, and (iii) has become known in the trade as a swap or security-based swap or has been otherwise structured as an identified banking product to evade regulation by the Commissions.

[13] The current definition of eligible contract participant includes several categories of persons or entities that are eligible to engage in financial transactions that require the person to be regulated or have a certain amount of assets. In addition to the categories described in this memorandum, the definition's categories of eligible entities include financial entities, insurance companies that are regulated by the state and investment companies that are regulated by the Investment Company Act of 1940, among others.