Dodd Frank, one year on

Paul Watterson Jr and Craig Stein of Schulte Roth & Zabel revisit key legislation brought in as a reponse to America's financial crisis

"Either the CFTC or the SEC may prohibit an entity from participating in the US swap markets if it is domiciled in a country whose regulation of swaps undermines the stability of the US financial system".

In July 2010, in response to the financial crisis of 2008/9 which resulted in the deepest economic recession in the United States since the Great Depression of the 1930s, the United States Congress passed, and President Obama signed into law, the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Act addresses a broad range of issues including consumer protection, rating agencies, systemic risk, executive compensation, private fund adviser registration, the so-called Volker Rule, and prudential risk regulation. A significant component of the Act is the regulation of derivatives and participants in derivative markets.

In *What the changes really mean* (IFLR Derivatives Supplement, July 2010), the same authors discussed the provisions of the Act. The main provisions of the legislation relating to derivatives are increased transparency, clearing and exchange trading requirements, regulation of swap dealers and other swap market participants, restrictions on swaps trading by banks and increased capital and margin requirements. It was left to the regulators to promulgate rules and regulations implementing many details of the Act. For almost a year now, the regulators have been proposing many rules and industry participants have been commenting on those proposals. On some issues, the industry is still anxiously awaiting proposed rules in order to obtain clarification of the Act. Due to the incredibly large volume of rules that the regulators were required to adopt and the long process for public comments on proposed rules, although parts of the Act were originally intended to become effective beginning July 16 2011, that date may be extended.

> **"The Volcker rule prohibits most proprietary trading in financial instruments including derivatives by banking institutions"**

Dual regulators

The Act provides for dual oversight of derivatives by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). The SEC will regulate "security-based swaps" while the CFTC will regulate other "swaps". The SEC and the CFTC will have joint jurisdiction over "mixed swaps" that contain components both of security-based swaps and other swaps. The Act requires that the SEC and CFTC must consult and coordinate with each other to the extent possible before engaging in rulemaking or issuing orders for the purposes of assuring regulatory consistency. The Act also requires the CFTC to consult and coordinate with foreign regulatory authorities on the establishment of international standards regarding futures to promote effective and consistent global regulation.

One of the big issues in the rulemaking process has been that the SEC and the CFTC have proposed rules that have not been harmonised. The consequence is that there may be different rules governing similar derivative products if one product falls into the category of swaps and the other similar product falls into the category of security-based swaps.

In April 2011, the two regulators jointly proposed rules and interpretive guidance on the definitions of swap, security-based swap, and mixed swaps. The proposed rules clarify that certain insurance products, consumer and commercial agreements, and loan participations are not swaps or security-based swaps, and that foreign exchange forwards, FX swaps and other FX products (that are not exempted by a US Treasury determination) and forward rate agreements are swaps.

The Act also left open the question as to whether or not many of the new requirements apply to FX swaps and forwards. In May 2011, the US Treasury proposed exempting FX swaps and forwards from the central clearing requirements of the Act.

(Any reference to swaps in this article, unless specifically addressed as CFTC-regulated, mean all swaps, security-based or otherwise.)

The Volcker rule

The so-called Volcker Rule prohibits, or authorises the Federal Reserve to prohibit, most proprietary trading in financial instruments including derivatives (other than for market making and hedging purposes) by banking institutions. There are exceptions for trading in US government, agency and municipal securities, hedging, transactions on behalf of customers, transactions in connection with underwriting and market making, transactions by insurance companies and transactions by non-US banking organisation outside the US. The Act authorises the banking regulators, the SEC and the CFTC to adopt rules permitting additional types of proprietary trading.

The rule also prohibits banking institutions from acquiring or retaining equity, partnership, or other ownership interests in, or sponsoring, any hedge fund or private equity fund, with limited exceptions.

As of the time of writing, the regulators have yet to issue proposed rules regarding the implementation of the Volcker rule. The Act gives federal regulators until September 2011 to release proposed rules on the proprietary trading ban. However, in January 2011, the US Financial Stability Oversight Council released its Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds as required by the Act.

Clearing requirements

One of the big changes is mandatory clearing of swaps through a derivatives clearing organisation (DCO), unless no clearing organisation will accept the transaction or the commercial end user exemption is satisfied. A commercial end user (or certain of its affiliates) can opt out of the clearing

requirement if it is hedging commercial risk. Section 723 of the Act authorises the CFTC and the SEC to determine which swaps should be required to be cleared. In addition, a DCO must register with the SEC or CFTC and its operations will be subject to extensive regulation. Section 745(b) of the Act directs the two regulators to prescribe criteria, conditions, or rules under which it will determine the initial eligibility or the continuing qualifications of a DCO to clear swaps.

In November 2010, the CFTC issued proposed rules regarding the process by which a DCO may become eligible to clear certain swaps and the process by which the CFTC will determine if such swaps are required to be cleared. The SEC issued its proposed rules in December 2010. Under the proposed rules, a DCO would be presumed eligible to accept for clearing any swap that is within a group, category, type, or class of swaps that the DCO already clears. A DCO that plans to accept for clearing any swap that is not within a group, category, type, or class of swaps that it already clears would be required to request a determination by the CFTC or SEC, as applicable, of its eligibility to clear the swap.

In April 2011, the CFTC issued its Proposed Rule on the Protection of Cleared Swaps Customer Contracts and Collateral and Conforming Amendments to the Commodity Broker Bankruptcy Definitions. The CFTC proposed using the complete legal segregation model. This model would allow a futures commission merchant (FCM) to commingle the cleared swaps collateral of all cleared swaps customers pre-bankruptcy. In the event of a default of both an FCM member and one or more of its cleared swaps customers, a DCO would have recourse against the collateral of defaulting customers, but not against the collateral of non-defaulting customers.

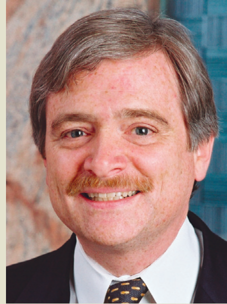
Trade execution requirements

All swaps that are subject to the new requirement that the transaction be cleared through a DCO also would be required to be traded on an exchange or a swap execution facility (SEF), unless no facility accepts the swap for trading. The Act defined an SEF as 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, including any trading facility that facilitates the execution of swaps between participants and is not a designated contract market.

In January 2011, the CFTC published a notice of proposed rulemaking (Core Principles and Other Requirements for Swap Execution Facilities) that provides guidance as to what types of entities would satisfy the swap execution facility definition. The proposed rules provide that one-to-one-to-one voice services for the execution or trading of swaps (other than for the execution of block trades), single-dealer platforms, and services that solely provide for the processing of swaps do not comply with the SEF definition. In February 2011, the SEC followed with its own proposed rules for SEFs. Under the SEC's interpretation of the definition, an SEF would be a system or platform that allows more than one participant to interact with the trading interest or more than one other participant on the system or platform. Various types of trading platforms could meet the proposed interpretation. The proposed interpretation would include a request-for-quote system that provides a participant with the ability to send a single request for a quote to all participants providing liquidity on that system, or to choose to send the request to fewer than all such participants.

The Act required the regulators to address potential conflicts of interest regarding SEFs through structural governance requirements and limits on the ownership of voting equity and the exercise of voting power. In October 2010, the CFTC published proposed rules entitled Requirements for Derivatives Clearing Organisations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest. The proposed rules prohibit members of SEFs from beneficially owning twenty percent or more of any class of voting equity in the facility or directly or indirectly voting an interest exceeding 20% of the voting power of any class of equity interest therein. In addition, the proposed rules impose specific board composition requirements on an SEF.

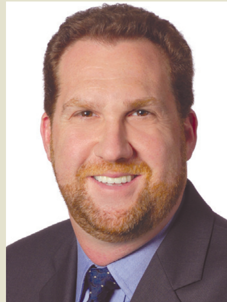
Author biographies



Paul N Watterson, Jr, partner
Schulte Roth & Zabel

Paul N Watterson is co-head of the structured products and derivatives group. He concentrates on structured product and derivative transactions, the formation and representation of credit funds, and capital markets regulation. He is counsel to many participants in the securitisation, credit and derivatives markets and represents underwriters, issuers and managers in structured financings, including collateralised loan obligations as well as being involved in structured finance transactions that use credit derivatives, including regulatory capital transactions and repackagings. Watterson advises private investment funds and other alternative investment vehicles on their transactions in derivatives, portfolios of loans, asset-backed securities and CDOs; he has also been active in the creation of derivative products that reference hedge funds.

After graduating from Princeton University, Watterson served as an officer at Chase Manhattan Bank in New York and London before attending Harvard Law School where he served as an editor of the Harvard Law Review. He also served as a law clerk to a judge of the US Court of Appeals for the Third Circuit and as an assistant to the Mayor of New York City.



Craig Stein, partner
Schulte Roth & Zabel

Craig Stein is co-head of the structured products and derivatives group. His practice focuses on swaps and other derivative products, including credit- and fund-linked derivatives, prime brokerage and customer trading agreements, and structured finance and asset-backed transactions. He represents issuers, underwriters and portfolio purchasers in public and private structured financings, including collateralised loan obligations. Stein has been recognised by leading peer-review publications as a leader in the industry. He has written for leading journals and weekly publications and spoken at conferences on hedge funds and innovative investment products. He is a member of the Isda Credit Derivatives Market Practice Committee, American Bar Association and New York State Bar Association.

In addition, on January 6 2011, the CFTC published Governance Requirements for Derivatives Clearing Organisations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interests, which establishes additional requirements for SEFs to mitigate conflicts of interest, including the implementation of a programme to identify conflicts of interest and a method to resolve the conflicts of interest.

Each SEF would be obligated to follow the additional core principles that are set forth in the Act and further enumerated by the proposed rules. For example, SEFs must meet specific financial resource requirements.

Swap dealers and major swap participants

The Act provides for capital and margin requirements to be set for banking entities by the applicable prudential regulator and for non-banking entities by the CFTC and the SEC.

The CFTC issued proposed rules regarding margin for swaps not cleared through a DCO. The rules apply to swaps entered into by swap dealers (SDs) or major swap participants (MSPs) that are not subject to oversight by prudential regulators. The rules do not impose margin requirements on commercial end users, defined under the proposed rules as non-financial entities. For trades between SDs/MSPs and other SDs/MSPs, the rules would require that initial and variation margin be paid and collected for each trade. For trades between SDs/MSPs and financial entities, the rules would require the SD/MSP to collect, but not pay, initial and variation margin for each trade. For trades between a SD/MSP and a non-financial entity, the rule would not require SDs/MSPs to pay or collect initial or variation margin from the non-financial entity. The rule only requires SDs/MSPs to enter into credit support arrangements with their non-financial counterparties and to abide by those arrangements.

The rules would apply to uncleared swaps entered into after the effective date of the regulation. The proposal would not apply retroactively.

SDs/MSPs would be required to accept certain specified assets as margin from other SDs/MSPs or from financial entities. Haircuts are specified in the proposed rule. Collateral for trades between SDs/MSPs and other SDs/MSPs would be required to be held at third party custodians and could not be rehypothecated. SDs/MSPs would be required to offer non-SDs/MSPs the opportunity to have any initial margin segregated.

In April 2011, the CFTC proposed rules regarding capital requirements for SDs and MSPs. The proposed rules address the SDs'/MSPs' qualifying capital and the minimum levels of such qualifying capital that the SD or MSP would be required to maintain. The proposed requirements govern SDs and MSPs that both are and are not FCMs. Under the proposed rules a SD or MSP may apply for CFTC approval to use internal models for purposes of its capital requirements.

The Act also requires that SDs/MSPs must notify their counterparties that such counterparties have the right to require that any initial margin which they post for uncleared swaps be segregated at an independent custodian. The CFTC has issued a proposed rule on Protection of Collateral of Counterparties to Uncleared Swaps. The rule provides that if a counterparty elects to have its initial margin segregated, the account must be held at a custodian that is independent of both the counterparty and the SD/MSP. There must be a written custody agreement among the parties and the custodian which meets certain standards specified in the rule.

The Act contained requirements that swaps not cleared through a DCO must be reported to a registered swap repository or, if there is no repository for the swap, to the SEC or CFTC. In October 2010, the SEC and the CFTC issued interim final temporary rules which required specified counterparties to pre-enactment swaps to report information relating to such swaps to a registered swaps depository or the SEC or CFTC, as applicable. Each of the regulators has proposed a number of rules regarding swap data record keeping and recording. The Act requires that at least one counterparty to a swap must report data concerning that swap to the swap data repository. Generally speaking the requirement to report falls on the SD/MSP.

The Act imposes many requirements on SDs and MSPs. These requirements include registration, reporting and recordkeeping, capital requirements, initial and variation margin requirements, business conduct standards and conflict of interest requirements.

The Act defines a dealer as (i) an entity that holds itself 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 one's own account; or (iv) engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps.

A major swap participant is any non-dealer (i) which maintains a substantial position in any of the major swap markets (excluding hedging positions); (ii) 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 (iii) is a highly-leveraged financial entity that is not subject to capital requirements established by an appropriate Federal banking agency and maintains a substantial position in outstanding swaps in any major swaps category.

The CFTC and the SEC have jointly proposed rules regarding what entities will be classified as dealers or as major swap participants.

In the release accompanying the proposed rule, the CFTC and the SEC note that, with respect to the definition of dealer, there "does not appear to be a single set of criteria that can be determinative in all markets," and also state that "rigid standards would not provide the necessary flexibility" for the CFTC and the SEC. The regulators note that there may be certain distinguishing characteristics of dealers, including that dealers tend to accommodate demand from other parties; dealers generally are available to enter into swaps to facilitate other parties' interests in entering into those instruments; dealers tend not to request that other parties propose terms of swaps, but instead enter into instruments on their own standard terms or on terms they arrange in response to other parties' interest; and dealers tend to be able to arrange customised terms for swaps upon request.

With respect to the definition of major swap participant, the proposed rule contains two tests to define "substantial position" and "substantial counterparty exposure". The first test looks at uncollateralised exposure and the second test looks at uncollateralised exposure plus potential future exposure. The proposed rule also defined what it means to be highly leveraged. The proposed rule contains specific thresholds that must be met to satisfy the test and, therefore, be categorised as a major swap participant. The regulators have solicited comments from market participants regarding how positions should be aggregated for entities that are under common control or ownership, and whether the SD/MSP business conduct requirements should fall on the parent company or on its subsidiaries.

Business conduct standards

The Act imposed business conduct requirements on SDs and MSPs, including requirements that they disclose risks and conflicts of interest. SDs and MSPs are also required to verify that potential

> "Security-based swaps now will be treated as securities for many purposes under the US securities laws"

counterparties meet eligibility requirements. The requirements for SDs or MSPs that advise or transact with so-called special entities, which include employee benefit plans, endowments and government entities, are more stringent. Advising a special entity gives rise to a fiduciary duty on the part of the SD. Where a special entity is a counterparty, the SD or MSP must have a reasonable basis to believe that the special entity has a representative that meets certain criteria, which include sufficient knowledge to evaluate the transaction and its risks.

The CFTC proposed a rule in December 2010 that would, among other conduct and anti-fraud requirements, require SDs and MSPs to disclose to all counterparties, within a reasonable time before entering into a swap, material risks of the swap, material characteristics of the swap and material incentives and conflicts of interest, including the mid-market value of the swap and any compensation that the SD or MSP will receive outside of the swap. With respect to special entities, if a SD acts as adviser to a special entity, it would be required to act "in the best interests" of the special entity and use "reasonable efforts" to determine that the trading strategy is in the best interests of the special entity. However, the CFTC declined in the proposed rulemaking to define "best interests".

Other issues

The Act authorised the SEC and the CFTC to impose aggregate limits on the number of positions in contracts based on an underlying commodity that perform or affect a significant price discovery function. There is an exception from the limitations for bona fide hedge position. In January 2011, the CFTC proposed a rule that would impose position limits on 19 agricultural, five metal and four energy commodities. The CFTC expects the position limits to affect only large commodities traders and the bona fide hedge position exclusion was maintained.

Security-based swaps now will be treated as securities for many purposes under the US securities laws. The reporting requirements in the US Securities Exchange Act will be amended to give the SEC authority to determine the circumstances in which a swap counterparty must file reports with the SEC as if it were the beneficial owner of the reference security. In March 2011, the SEC issued a release proposing to re-adopt, without change, the beneficial ownership rules with respect to security-based swaps. The purpose of the release was to make clear that the Act would not supersede existing beneficial ownership rules relating to security-based swaps.

The Act grants authority to the SEC and the CFTC to issue reports on any types of swaps which they consider detrimental to the stability of the financial markets. Although neither commission has proposed any rules regarding abusive swaps, the CFTC has issued a proposed interpretive order fleshing out the prohibitions on "Disruptive Trading Practices" contained in the Act. Under the Act, it is unlawful for any market participant to engage in trading practices that violate bids or offers, disregard orderly trade execution during the market's closing period, or are commonly known as spoofing – that is, bidding or offering with the intent to cancel before execution.

Extraterritorial issues

Either the CFTC or the SEC (in consultation with the US Treasury) may prohibit an entity from participating in the US swap markets if it is domiciled in a country whose regulation of swaps undermines the stability of the US financial system. Generally, the new rules affecting swaps regulated by the CFTC will not apply to most activities in swap markets outside the US, unless those activities have a direct and significant connection with activities in the US or effect on the US. The new rules affecting security-based swaps regulated by the SEC will not apply to transactions outside of US jurisdiction, unless they are transacted to evade the provisions of the Dodd-Frank Act and the SEC's rules thereunder. The regulators may adopt regulations restricting activities in swap markets outside the US in order to prevent evasion of the new US rules.

The regulators have not yet commented on what constitutes a "direct and significant" connection, although the CFTC has solicited comments from market participants regarding, for SDs, what level of dealing activity outside of the US with non-US affiliates of US persons would have a direct and significant effect on activities in the US and, for MSPs, threshold levels of trading with US counterparties and use of US clearing and swap execution facilities by non-US entities.

Implementation

The Act establishes many different deadlines for the issuance of rules by the regulators. In fact, many of the rulemaking provisions in the Act do not expressly provide a deadline for when the required or permitted rule should be issued. Congress is currently considering a formal extension of the deadlines, but CFTC Chairman Gary Gensler has stated that while not every rule will be final by the applicable deadline, an extension is not necessary. The CFTC, however, has recently extended the comment period on all rules by 30 days (whether or not the comment period has already closed). The SEC staff has indicated that the SEC is likely to delay the process for registration of mid-sized investment advisers and advisers relying on the private-adviser exemption until 2012.

Nearly one year after the enactment of the most comprehensive law on the regulation of derivatives in the US, we are still in the middle of a lengthy rulemaking process. As such, industry participants still do not have clear guidance on the new derivatives landscape.

Schulte Roth & Zabel

Schulte Roth & Zabel LLP
919 Third Avenue, New York, NY 10022
212.756.2000 tel | 212.593.5955 fax | www.srz.com
New York | Washington DC | London