

Dodd-Frank: The Regulatory Reset of the OTC Derivatives Markets

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") provides, for the first time, a comprehensive regulatory framework for the over-the-counter ("OTC") derivatives markets. Fundamentally, Title VII aims to prevent future financial crises by mandating robust market and transaction-level transparency, while reducing structural leverage and systemic risk throughout the derivatives markets. While significant portions of Title VII remain subject to rulemaking by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"), Title VII codifies the global de-risking process underway since the start of the financial crisis, with a particular focus on:

- Reducing counterparty risk and enhancing transparency and price discovery by requiring clearing and exchange trading for eligible derivatives contracts;
- Deleveraging the OTC derivatives markets by imposing new regulatory capital and margin requirements on OTC swap dealers ("swap dealers") and most large OTC swap participants ("major swap participants");
- Requiring swap dealers and major swap participants to register with the SEC and/or CFTC and to continuously disclose detailed information regarding their derivatives trading; and
- Prohibiting Federal guarantees and other assistance from being provided to insured depository institutions involved in the swaps markets, subject to exceptions for certain types of swaps activities and affiliated swap dealers.

To help accomplish these goals, Title VII allocates jurisdiction over the OTC derivatives markets largely between the SEC, for "security-based swaps" and participants in the security-based swaps markets, and the CFTC, for all other "swaps" and participants in the swaps markets. The SEC, for example, will be the regulatory authority responsible for imposing new capital and margin requirements on security-based swaps, such as equity forwards and options, while the CFTC will have analogous authority over swaps other than security-based swaps, such as commodity forwards and options.

For ease of reference, the terms "swap," "swap dealer," and "major swap participant" will be used to include, respectively, the terms "security-based swap," "security-based swap dealer," and "major security-based swap participant," unless the context otherwise distinguishes the terms.

What OTC Derivatives Are Covered

Swaps

The scope of Title VII is intended to encompass nearly all commonly traded OTC derivatives, including options on interest rates, currencies, commodities, securities, indices, and various other financial or economic interests or property. The term "forward" is not expressly included in the swap definition. However, a physically settled forward sale of a nonfinancial commodity or security is expressly excluded from the definition, suggesting that other forward contracts are included in the "swap" definition.

The swap definition also includes contracts in which payments and deliveries are dependent on the occurrence or non-occurrence of certain contingencies, such as credit default swaps, plus swaps on rates and currencies, total return swaps and various other common swap transactions.

Security-Based Swaps

As part of the bifurcation of CFTC and SEC jurisdiction noted above, Title VII provides an analogous definition for a “security-based swap,” which will be subject to SEC oversight.

A security-based swap is essentially a transaction that would be categorized as a “swap” under Title VII but which references a narrow-based security index or a single security or loan, or a swap that is based on the occurrence or non-occurrence of an event relating to a single issuer of a security or the issuers of the securities in a narrow-based index. For purposes of defining the term “security,” the security-based swap definition does not cross-reference other federal securities laws or otherwise provide a definition for the term.

Foreign Exchange Swaps and Forwards

Foreign exchange (“FX”) swaps and forwards will be considered “swaps” and subject to regulation under the Act, unless the Secretary of the Treasury determines that such transactions should not be regulated under, and have not been structured to evade, Title VII.

Banks, dealers, and other institutions traditionally have been the primary participants in the FX swaps and forwards markets. These markets have been exempt from regulatory oversight since a 1974 Treasury Department request (the so-called “Treasury Amendment”) not to burden these participants with unnecessary regulation. While it is unknown whether the Secretary of the Treasury will seek to exclude FX swaps and forwards from Title VII regulation, there will be tremendous pressure to do so. The FX markets are among the deepest, most liquid markets in the world. Participants in these markets did not encounter the excessive leverage, risk or illiquidity seen in other OTC derivatives markets during the financial crisis.

Commodity-Based Swaps

While the commodities markets were not central to the financial crisis, Title VII does include a potentially fundamental change to the definition of “commodity pool operator” (“CPO”). A CPO now will expressly include any person that sponsors a pool for the purpose of investing

in commodity futures and options, including commodity-based swaps.

Prior to Title VII, a sponsor of a pool that invested synthetically in commodity futures and options through swaps likely would not have been deemed a CPO. In addition, a CFTC rule, 17 C.F.R. §4.5 (“Rule 4.5”), expressly excludes from the CPO definition any investment company registered with the SEC, among other qualifying entities. Many mutual funds, for example, engage in commodity swaps trading, through wholly owned subsidiaries, and are not subject to CFTC registration as a CPO. It is unclear if this change in Title VII is intended to expand the scope of CFTC jurisdiction to include such commodity-based mutual funds.

This uncertainty was recently underscored when the National Futures Association (“NFA”) proposed in late June to eliminate the mutual fund definitional exclusion from Rule 4.5. If the CFTC were to adopt the NFA’s proposal, a mutual fund that engages in commodity-based swap trading would likely be subject to both SEC and CFTC jurisdiction and regulatory oversight.

What OTC Derivatives Are Not Covered

The swap definition excludes, among other products, commodity futures and physically settled sales of non-financial commodities for deferred shipment. The latter exclusion is intended to permit non-financial businesses that engage in physical trading, such as food processing companies, to continue operating outside the confines of Title VII.

The swap definition also excludes any agreement that is based on a security and entered into with an underwriter for the purpose of raising capital, unless the agreement is entered into to manage a risk associated with capital raising. It is not clear whether a standard interest rate swap, for example, to convert a floating interest rate on a bond to a fixed rate, is an agreement to manage a risk associated with capital raising. The SEC and the CFTC (together, the “Commissions”) are not charged with clarifying this or other exclusions from the swap definition.

Major Swap Participants

Under Title VII, market participants other than swap dealers active in the derivatives markets may be considered “major swap participants” and subject to new regulatory capital, margin, reporting, and record-keeping requirements.

A “major swap participant” is defined as a person:

- (i) who maintains a “substantial position” in swap transactions, excluding positions held for hedging or mitigating the commercial risk of a company (commonly referred to as a “commercial end user”) and positions held by employee benefit plans;
- (ii) whose outstanding swaps create “substantial counterparty exposure” that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
- (iii) who is a financial entity that (a) is highly leveraged relative to the amount of capital it holds, and that is not subject to capital requirements established by an appropriate federal banking agency and (b) maintains a substantial position in outstanding swaps transactions.

Title VII provides the SEC with jurisdiction over a “major security-based swap participant,” which is essentially a major swap participant with positions in security-based swap transactions.

What Does “Substantial Position” Mean?

The Commissions are required to define “substantial position” as the amount prudent for the effective oversight of market participants that are “systemically important or can significantly impact the financial system of the United States.”

At the outset, this appears to be a significant threshold. While certain institutions prior to the financial crisis engaged heavily in derivatives trading and required Federal bailouts or other government support, it may be difficult to conclude that the derivatives trading of a majority of mutual funds or hedge funds could “significantly impact the financial system of the United States.”

Moreover, while earlier iterations of the legislation were silent on whether margin is relevant to this analysis, Title VII states that the Commissions may take into account the value and quality of collateral held against counterparty exposure. Therefore, if a major swap participant is periodically collateralizing its derivatives exposure, as is already required of mutual funds, it seems even less likely that a given fund’s trading could have a significant impact on the U.S. financial system.

In addition, there is no indication as to whether the “substantial position” will be determined across affiliated entities, such as across multiple funds or managed accounts advised by a single manager, or whether it will be determined on a person-by-person basis (e.g., long positions against short positions within a single portfolio).

While the legislation does not specify whether a fund, or the investment manager of the fund, would be potentially categorized as a major swap participant, it would appear that the fund itself would be the appropriate entity. The capital available for satisfying the newly imposed margin requirements on major swap participants (discussed below) would be sourced from the fund’s balance sheet. And, the losses that would occur from a counterparty default from a non-cleared swap would accrue to the equity holders of the fund.

What Does “Substantial Counterparty Exposure” Mean?

Aside from questions surrounding the “substantial position” definition, the determination of what will constitute “substantial counterparty exposure” is also unclear and the Commissions are not charged with providing a definition.

While a hedge fund may have \$10 billion in outstanding swaps facing an individual dealer, a \$10 billion counterparty exposure to a dealer with a \$1 trillion balance sheet – i.e., 1% of the dealer’s assets – might not be considered “substantial” to the degree of affecting the financial stability of the United States. From the hedge fund’s perspective, the exposure could be substantial, but it is not evident that such exposure could be systemically important to the U.S. financial markets. It would be even less important if the swap transactions were collateralized, as will be required under Title VII.

As a general matter, the effectiveness of using regulatory standards such as “substantial position” and “substantial counterparty exposure” will be largely determined by the effectiveness of the Commission’s regulatory capital and margin requirements. Frequent mark-to-market collateralization will effectively deleverage the derivatives trading of major swap participants and swap dealers. In the event of a disruption in the derivatives markets, collateralized counterparties will be in a position to promptly terminate transactions, foreclose on posted collateral, and remain subject only to their intervening, uncollateralized derivatives exposure.

Captive Finance Company Exclusion

Title VII excludes from the “major swap participant” definition a captive finance company that meets the following criteria:

- (i) its primary business is to provide financing;
- (ii) it uses derivatives for the purpose of hedging commercial risks related to interest rate and FX exposures;
- (iii) 90% or more of these interest rate and FX exposures arise from financings that facilitate the purchase or lease of products; and
- (iv) 90% or more of these products are manufactured by the captive finance company’s parent company or another subsidiary of the parent company.

Swap Dealers

Under Title VII, banks, dealers, and other financial institutions active in the derivatives markets may be considered “swap dealers” and subject to similar capital, margin, reporting, and record-keeping requirements as major swap participants.

A “swap dealer” is defined 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 in the ordinary course of business for its own account; or
- (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

As with the “major swap participant” definition, Title VII includes a substantially similar definition for a “security-based swap dealer,” subject to SEC jurisdiction, that deals primarily in security-based swap transactions.

Unknown at this point is what may constitute a person “hold[ing] itself out as a dealer in swaps” or purchasing or selling swaps in the “ordinary course of business.” If a hedge fund regularly enters into swaps with counterpar-

ties in its ordinary course of business, it is possible that a hedge fund could be deemed a swap dealer. There is also a question whether a hedge fund could be deemed simultaneously a swap dealer and a major swap participant. More troubling, even a commercial end user may regularly enter into swaps with counterparties in its ordinary course of business, such as a global manufacturing company that engages in interest rate risk hedging.

Title VII does not task the Commissions with defining the phrases “hold[ing] itself out as a dealer in swaps” or “ordinary course of business.”

Exemptions from the “Swap Dealer” Definition

The following entities are expressly exempt from the “swap dealer” definition:

- (i) an insured depository institution to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer;
- (ii) an entity that buys or sells swaps for such person’s own account, either individually or in a fiduciary capacity, and not as “part of a regular business;” and
- (iii) an entity that engages in a “*de minimis* quantity” of swap dealing in connection with transactions with or on behalf of its customers.

The Commissions are charged with promulgating regulations to establish factors in making the determination of a “*de minimis* quantity.”

Consequences of Being a Swap Dealer or Major Swap Participant

Registration

Each swap dealer and major swap participant is required to register with the CFTC or SEC, depending on whether such swap dealer’s or major swap participant’s derivatives business involves swaps or security-based swaps. Registration will be required with both Commissions if an entity’s business involves both swaps and security-based swaps. The Commissions are charged with developing the form and manner of this registration.

Swap dealers and major swap participants will be required to submit on-going reports containing such information relevant to their swaps business as the

Commissions may require. Moreover, the CFTC and SEC are authorized to take actions that “limit the activities” of market participants registered with the Commissions. Title VII, however, does not indicate what actions the Commissions may take in limiting the derivatives trading of market participants.

Commission rules must provide for the registration of swap dealers and major swap participants within one year after the date of enactment of the Act.

New Regulatory Capital and Margin Requirements

Title VII provides the regulatory means for a wholesale deleveraging of the OTC derivatives markets. Each registered swap dealer and major swap participant, and any swap dealer or major swap participant for which there is a prudential regulator, such as the Federal Reserve (“Fed”) or the Federal Deposit Insurance Corporation (“FDIC”), must meet new minimum capital standards and initial and variation margin requirements for non-cleared swaps (cleared swaps will be subject to existing margin requirements mandated by the relevant clearinghouse).

In terms of the amount of additional regulatory capital required, the Act mandates that such amounts must help ensure the safety and soundness of the market participant and be appropriate for the risk associated with the non-cleared swaps in the market participant’s trading book.

As noted above, it is unknown whether these capital and margin requirements on funds will apply specifically to the fund or to the fund’s manager, which will have discretionary authority to enter the derivatives transactions. Presumably, given that the available assets to meet these new requirements will come from the fund, and that the profit-and-loss on the derivatives positions will accrue to the fund, the capital and margin requirements would similarly be placed on the fund.

Title VII’s compulsory capital and margin requirements will remove a substantial degree of leverage and risk-taking from the derivatives markets. While reduced risk in the derivatives markets may be welcomed, there are downsides to the requirements. Market participants, for example, may not have the asset capacity to enter into certain types of derivatives transactions. Additional capital and margin requirements will also reduce returns on investments and, in a time of difficult financial conditions, will have the perverse effect of extracting available capital from the economy.

New Reporting and Record-Keeping Obligations

Each swap dealer and major swap participant will be required to provide reports to the Commissions regarding their transactions, positions and financial condition. Daily trading records will need to be maintained, as well as related records and recorded communications (such as email, instant messaging and recorded telephone calls), for such period of time as the Commissions may require.

Each swap dealer and major swap participant will also be required to maintain books and records of all activities related to its business, in such form and manner and for such period of time as the Commissions may require. These books and records must be available for inspection by the relevant Commission, the Department of Justice, appropriate Federal banking agencies, and other regulators. Swap dealers and major swap participants will further be required to maintain a complete audit trail for conducting comprehensive and accurate trade reconstructions.

These provisions of Title VII were clearly influenced by the high concentration of derivatives referencing mortgage-backed securities in the trading books of various dealers and funds. The on-going reports and other market information will allow regulators to second-guess the trading strategies of registered swap dealers and major swap participants. Regulators will have the legal authority to review, for example, risk concentrations in derivatives positions, and potentiality to impose concentration, diversity, and liquidity restrictions on market participants’ portfolio management activities.

New Business Conduct Standards for Swap Dealers and Major Swap Participants

While inadequate margining and excessive asset concentration were more central to the collapse of the derivatives markets, Title VII also seeks to ensure that market participants will comply with adequate business conduct standards in the operation of their derivatives trading.

Each swap dealer and major swap participant will be required to satisfy business conduct standards adopted by the Commissions that will:

- (i) establish a duty to verify that any counterparty meets the eligibility standards for an eligible contract participant (which under the Commodity Exchange Act is an institutional buyer, governmental entity, high-net worth individual or other sophisticated counterparty);

- (ii) require disclosure to any counterparty to a transaction of:
 - (a) information related to the material risks and characteristics of the swap transaction;
 - (b) any material incentives or conflicts of interest that the swap dealer or major swap participant may have in connection with the swap transaction;
 - (c) for cleared swaps, the daily market value of the transaction from the appropriate derivatives clearing organization; and
 - (d) for non-cleared swaps, the daily market value of the transaction from the swap dealer or major swap participant;
- (iii) establish a duty for a swap dealer and major swap participant to communicate in a fair and balanced manner, based on principles of fair dealing and good faith; and
- (iv) establish such other standards and requirements as the Commissions may determine are appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

Special Requirements When Acting as an Advisor to a Special Entity

A swap dealer or major swap participant that acts as an advisor to a governmental plan or entity, employee benefit plan or endowment, referred to as a “Special Entity,” must adhere to a higher standard of conduct, and a swap dealer (but not a major swap participant) must act in the best interests of such Special Entity.

For example, a swap dealer that acts as an advisor to a Special Entity must make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap recommended by the swap dealer is in the best interests of the Special Entity, including such information relating to the Special Entity’s financial status, tax status, investment or financing objectives, and any other information that the Commissions may prescribe.

Special Requirements When Acting as a Counterparty to Special Entity

A swap dealer or major swap participant that acts as a counterparty to a Special Entity must adhere to any duty established by the relevant Commission that requires the swap dealer or major swap participant to have a reasonable basis to believe that the Special Entity has an independent representative that:

- (i) has sufficient knowledge to evaluate the transaction and risks;
- (ii) is not subject to statutory disqualification;
- (iii) is independent of the swap dealer or major swap participant;
- (iv) undertakes a duty to act in the best interests of the counterparty it represents;
- (v) makes appropriate disclosures;
- (vi) will provide written representations regarding fair pricing and the appropriateness of the transaction; and
- (vii) in the case of employee benefit plans, is a fiduciary.

Commercial End Users

A commercial end user is a counterparty to a swap that is not a “financial entity” and that is using the swap to hedge or mitigate commercial risk. A “financial entity” can be a swap dealer, major swap participant, commodity pool, certain private funds, an ERISA plan, and certain banking entities. Commercial end users are exempt from the “major swap participant” definition and the related regulatory oversight of major swap participants.

In addition, if a swap is required to be cleared and one party to the swap is a commercial end user, that party may choose not to clear the swap. The legislation further provides commercial end users with the option to choose their clearinghouse or clearing agency and the option to segregate margin with an independent third-party custodian.

Clearing Requirements for Swaps

What Swaps Need to be Cleared?

Title VII requires clearing of all swap transactions that are acceptable to a “derivatives clearing organization” (“DCO”) for clearing, other than, as noted above, any swaps for which one of the counterparties is a commercial end user. A DCO must submit to the relevant Commission for prior approval any group, category, type, or class of swaps the DCO seeks to clear. To avoid delays, the relevant Commission must respond to any such DCO request within 90 days of the submission of the request.

DCOs are required to treat all swaps (but not commodity futures or options thereon) submitted to the DCO with the same terms and conditions as being economically equivalent and able to be offset against each other. DCOs are further required to provide for non-discriminatory clearing of a swap (but not a commodity future or option thereon) executed bilaterally or on or through the rules of an unaffiliated contract market or swap execution facility (discussed below).

In terms of the initial products that may be cleared, DCOs are likely to build upon the existing universe of cleared swap transactions, such as single-name and index-based credit default swaps. Interest rate swaps, which may be readily standardized as to payment dates and maturities, would likely be another category of swaps first to be cleared by a DCO.

Status of Non-Cleared Swaps

Parties to a swap that is not accepted by a DCO will be required to report the swap to a “swap data repository” or “SDR.”

Swap Data Repository

An SDR is generally any person that collects, calculates, and prepares information or records related to transactions or positions in, or the terms and conditions of, swaps entered into with third parties. The data collection and data maintenance standards for SDRs will be determined by the relevant Commission. Swaps entered into before the enactment of the Act will be required to be reported to an SDR within 30 days of issuance of an interim final rule on the reporting of swaps, which in turn must be promulgated by the relevant Commission within 90 days of the effective date of the Act.

Status of Existing Swaps

Swaps entered into before the date of enactment of the Act are exempt from the clearing requirements, provided these swaps are reported to an SDR.

Commercial End User Exemption

Title VII does not require a swap to be cleared if one of the counterparties to the swap:

- (i) is *not* a “financial entity;”
- (ii) is using swaps to hedge or mitigate commercial risk; and
- (iii) notifies the relevant Commission how it meets its financial obligations under the non-cleared swap.

As noted above, a “financial entity” includes a swap dealer, major swap participant, commodity pool, certain private funds, certain ERISA plans, and certain banking entities. This definition is intended to *exclude* commercial end users that enter into swaps to hedge or mitigate commercial risks. In a June 30, 2010 letter (the “Dodd-Lincoln Letter”), Senators Christopher Dodd (D-Conn) and Blanche Lincoln (D-Neb) attempted to address concerns that Title VII would make it more difficult for non-financial businesses to continue their ordinary physical trading and manage their commercial risks through OTC derivatives. The Dodd-Lincoln Letter states that Congress “created a robust end user clearing exemption for those entities that are using the swaps market to hedge or mitigate commercial risk....These entities did not get us into this crisis and should not be punished for Wall Street’s excesses.”

Derivatives Clearing Organizations

Clearing of swaps is a cornerstone of the derivatives reform legislative agenda and a key element of Title VII’s focus on risk reduction. Accordingly, to be registered and to maintain registration as a DCO, a DCO must meet an extensive set of criteria, with the most important criteria set forth below:

- (i) each DCO must have adequate financial, operational and managerial resources, as determined by the relevant Commission;
- (ii) each DCO must possess financial resources that, at a minimum, exceed the total amount that would
 - (a) enable the DCO to meet its financial obligations

to its members and participants, notwithstanding a default by the member or participant creating the largest financial exposure for that DCO in “extreme but plausible market conditions;” and (b) enable the DCO to cover the costs of the DCO for a one-year period;

- (iii) on an on-going basis, each DCO must establish and implement procedures to verify the compliance by members and participants with each participation and membership requirement of the DCO;
- (iv) each DCO must (a) not less than once during each business day, measure the credit exposures of the DCO to each member and participant of the DCO, and (b) monitor each such exposure periodically during the business day of the DCO;
- (v) through margin requirements and other risk control measures, each DCO must limit the exposure of the DCO to potential losses from default by members and participants of the DCO;
- (vi) each DCO must have rules and procedures designed to allow for the efficient, fair, and safe management of events in the event of a member or participant insolvency; and
- (vii) with respect to conflicts of interest, each DCO must establish and enforce rules to minimize conflicts of interest in the decision-making process of the DCO.

Exchange Trading of Swaps

Title VII mandates that a swap that is cleared on a DCO must be traded on a board of trade designated as a “contract market” (i.e., a futures exchange) or a swap execution facility (“SEF”).

Swap Execution Facility

A SEF is a facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants in the facility or system through any means of interstate commerce.

Given that the initial exchange trading of swaps is likely to be relatively illiquid, it is unclear whether swap participants will be required to transact directly with the relevant exchange or if participants may contact dealers off the exchange to initiate a transaction, provided that the execution of the swap prints on the relevant exchange.

Swap Push-Out Rule

Among the most contentious aspects of the U.S. government’s response to the financial crisis was the eventual Federal guarantee of derivatives dealers’ trading books. Many dealers assumed, correctly it turned out, that, in the event of a systemic collapse of the markets, the Federal government would underwrite the risk inherent in a derivatives portfolio to avoid an even larger economic meltdown. Accordingly, with the “Bernanke Put” in place, derivatives traders enjoyed the asymmetrical return profile of a trading strategy involving substantial, unlimited upside, with the downside risk allocated to the Federal government.

A key measure of Title VII is to remove this implicit Federal guarantee of derivatives trading. The “Swap Push-out Rule,” as it is known, prohibits providing “Federal assistance” to depository institutions that constitute “swaps entities” and also contains several important exemptions for qualifying insured depository institutions.

“Federal assistance” is defined as the use of any advances from any Federal Reserve credit facility or discount window (that is not part of a facility with broad-based eligibility under Section 13 of the Federal Reserve Act), or FDIC insurance or guarantees, for the purpose of:

- (i) making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity;
- (ii) purchasing the assets of any swaps entity;
- (iii) guaranteeing any loan or debt issuance of any swaps entity; or
- (iv) entering into any assistance arrangement, loss sharing, or profit sharing with the swap entity.

A “swaps entity” is any swap dealer or major swap participant that is registered with the CFTC or SEC, but does not include any major swap participant that is also an insured depository institution.

Exemptions from the Swap Push-Out Rule

An FDIC-insured depository institution will not be subject to the prohibition on Federal assistance if its swap activities are limited to:

- (i) hedging and other similar risk-mitigating activities directly related to the insured depository institution’s activities;

- (ii) acting as a swaps entity for swaps involving rates or reference assets permissible for investment by a national bank under applicable banking law; and
- (iii) acting as a swaps entity for credit default swaps that are cleared by a DCO or a clearing agency.

In addition, the term “swaps entity” does not include certain insured depository institutions in conservatorship or receivership.

Affiliated Swaps Entities

Title VII’s prohibition on Federal assistance does not apply to, and does not prevent an FDIC-insured depository institution from establishing and maintaining, an affiliate that is a swaps entity, provided that the following conditions are satisfied:

- (i) the depository institution is part of a bank holding company or savings and loan holding company that is supervised by the Fed; and
- (ii) the affiliated swaps entity complies with Sections 23A and 23B of the Federal Reserve Act and any other requirements that the CFTC, SEC and the Fed may determine necessary.

Effective Date for Swap Push-Out Rule

The Swap Push-out Rule will be effective two years after the effective date of the relevant provisions of Title VII, which is 360 days after the date of enactment of the Act.

In addition, if an insured depository institution qualifies as a “swaps entity” and therefore is ineligible for Federal assistance, the applicable Federal bank regulator with jurisdiction over the institution will give the institution up to a 24-month transition period to divest the swaps entity or cease the activities that require registration as a swaps entity, plus the possibility of a one-year extension.

In establishing the appropriate transition period for any such divestiture or cessation of derivatives-related activities, the applicable Federal bank regulatory agency will take into account the potential impact on the insured depository institution’s:

- (i) mortgage lending;
- (ii) small business lending;
- (iii) job creation; and

- (iv) capital formation versus the potential negative impact on insured depositors and the FDIC’s Deposit Insurance Fund.

Effect of Swap Push-Out Rule on Existing Swaps

Insured depository institutions that have entered into swaps before the expiration of the transition period in which the institution must divest itself of the swaps entity (i.e., two years, plus a possible additional one year) do not have to unwind existing swaps to continue to receive Federal assistance.

Public Availability of Swap Data

As part of the emphasis on enhanced transparency in the derivatives markets, Title VII mandates that certain information regarding swap transactions be made publicly available. The Commissions are required to provide by rule for the public availability of the following swap transaction and pricing data:

- (i) with respect to a cleared swap, the Commissions will require real-time public reporting, which will include price and volume as soon as technologically practicable after the time at which the swap transaction has been executed; and
- (ii) with respect to a non-cleared swap that is reported to an SDR, the Commissions will require real-time public reporting, but only in a manner that does not disclose the transaction and market position of any person.

With respect to the rules providing for the public availability of swap transaction and pricing data, the rules promulgated by the Commissions must contain provisions that:

- (i) ensure such information does not identify the participants;
- (ii) specify the criteria for determining what constitutes a large notional swap transaction for particular markets and contracts;
- (iii) specify the appropriate time delay for reporting large notional swap transactions to the public; and
- (iv) take into account whether public disclosure will materially reduce market liquidity.

Segregation Requirements for Cleared Swaps

All collateral posted by a swap customer to margin, guarantee or secure a swap cleared by a DCO or a clearing agency must be held with a futures commission merchant (“FCM”), or a broker, dealer, or security-based swap dealer (for security-based swaps). The FCM, broker, dealer, or security-based swap dealer must separately account for all such customer property and may not commingle such property with its own funds. However, any such customer property may be commingled and deposited in the same account with any bank, trust company or DCO/clearing agency.

Segregation Requirements for Non-Cleared Swaps

While segregation for cleared swaps is similar to existing segregation requirements in the futures markets, Title VII also requires, for the first time, segregation of collateral for non-cleared swaps upon request by a counterparty. A swap dealer or major swap participant must inform the counterparty at the beginning of a swap transaction that the counterparty has the right to require segregation of collateral posted to margin, guarantee, or secure the obligations of the counterparty.

Upon request, the swap dealer or major swap participant must segregate the funds or other property and maintain such funds or other property in a segregated account separate from the assets of the swap dealer or major swap participant. The segregated account must be carried by an independent third-party custodian and designated as a segregated account for and on behalf of the counterparty. These segregation requirements, however, do not apply to variation margin payments.

Conclusion

Title VII of the Act will have profound effects on the regulation of the OTC derivatives markets, primarily through the institution of comprehensive market transparency, deleveraging and risk reduction. The full impact of Title VII, however, will not be known until the extensive rulemaking by the Commissions has been finalized. We will continue to monitor and report on the rulemaking process and related developments in the full roll-out of Title VII.



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