financial reform matters

ROPES & GRAY

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The Impact of Financial Reform: The Federal Regulation of OTC Derivatives

The Wall Street Transparency and Accountability Act of 2010 (the "Derivatives Act")–Title VII of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act")–will change federal regulation of OTC derivatives in important ways, some yet to be determined.

Congress set out the broad outlines of the regulation; it has left the details to be completed by the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC), with input from federal banking regulators (FBR) such as the Federal Reserve Board. The Derivatives Act requires these agencies to adopt related rules (with some exceptions) no later than July 16, 2011, which is the general effective date of the new law.

Three elements of the Derivatives Act have particular importance for our buy-side clients: (1) federal registration requirements; (2) clearing, trading, and margin requirements; and (3) dealer push-out and Volcker Rule requirements.

Federal Registration Requirements

Some of the things we know

- The SEC and CFTC will have split oversight of OTC derivatives, with the CFTC receiving the lion's share of authority. The SEC will regulate "security-based swaps" such as swaps based on a single security or single loan or narrow-based security or loan index and CDS based on a single issuer of securities or issuers of securities in a narrow-based index. The CFTC will oversee other derivatives, including swaps based on interest rates, broad-based security indexes, and foreign currencies.

- Non-bank "swap dealers" must register with the CFTC and non-bank "security-based swap dealers" must register with the SEC. "Dealers" include: (a) entities that hold themselves out as dealers; (b) entities that are commonly known as dealers; (c) entities that make a market in regulated derivatives; or (d) entities that regularly enter into swaps/security-based swaps with counterparties in the ordinary course of business for their own account.

- "Major swap participants" (MSP) and "major security-based swap participants" (MSSP) must register with the CFTC and SEC, respectively. These include: (a) entities that maintain a substantial position in any major swap or security-based swap category as determined by the CFTC/SEC but excluding positions hedging or mitigating commercial risks or maintained by an employee benefit plan under ERISA for the primary purpose of hedging any risk directly associated with the operation of the plan; (b) entities whose derivatives create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; and (c) financial entities that are highly leveraged relative to capital held, are not subject to capital requirements set by a FBR (like the Federal Reserve Board), and maintain a substantial position in any major swap/security-based swap category as determined by the CFTC/SEC.

- The definition of a “commodity pool” has been expanded to include pooled vehicles that trade swaps, and the definitions of “commodity pool operator,” “commodity trading advisor,” “futures commission merchant,” “floor broker,” “floor trader,” and “introducing broker” have been broadened similarly. As a result, to use swaps, pooled vehicles, investment advisers, and brokers (and their associated persons) may need to register with the CFTC and become members of the National Futures Association (NFA).

Some of the things we don’t know

- Who will be considered a “swap dealer”? Any hedge fund or mutual fund that “regularly enter[s] into . . . swaps . . . in the ordinary course of business” could potentially be caught up under that definition.
- How broadly will the regulators throw the net to include non-dealers in the “major swap participant” category?
- What happens to foreign exchange swaps and forwards? Note that, even if the Secretary of the Treasury excludes them from the definition of “swap,” users will still be required to report these positions.

What we think might happen

- The CFTC will assert itself as the primary regulator of derivatives, attempting to overcome doubts about its experience and resources.
- Notwithstanding the breadth of the statutory definition, regulators may well construe the “dealer” definition narrowly, to include for the most part only traditional dealers in the market.
- Similarly, the MSP/MSSP registration requirements may be limited to only the largest non-dealer entities. This may include some large hedge funds and other pools.
- The CFTC and SEC will pressure foreign regulators to develop comparable or complementary regulatory structures to avoid regulatory arbitrage by U.S. market participants. That may take longer to accomplish than the period until effectiveness of the new U.S. scheme, leaving open, for a time at least (or potentially indefinitely), the possibility of an increase in off-shore activity.

Clearing/Trading/Margin Requirements

Some of the things we know

- The CFTC and SEC will be required to publish lists of derivatives that should be cleared.
- Each swap/security-based swap that is required to be cleared will have to be traded on a board of trade designated as a contract market (DCM), securities exchange, or swap execution facility (SEF) unless no DCM, securities exchange, or SEF accepts the swap for trading.
- Swaps/security-based swaps entered into before the effective date of the clearing requirement are exempt from the clearing requirement if those swaps/security-based swaps are reported to a registered swap data repository or, if no repository accepts a report for a category of swap/security-based swap, to the CFTC/SEC. All uncleared swaps will also need to be reported.
- For any cleared swap/security-based swap between a dealer and a client that is not a MSP/MSSP, the client has the right to choose the clearing house for the trade.
- The CFTC and SEC will implement aggregate position limits across different types of markets, including not only traditional futures markets but also swap execution facilities and OTC trading in swaps that perform a “significant price discovery function with respect to a registered entity.”

- Uncleared transactions to which dealers or MSPs/MSSPs are parties will be subject to minimum initial and variation margin requirements set by the regulators. In addition, dealers and MSPs/MSSPs will have to meet capital requirements set by their regulators for various types of derivatives transactions, including uncleared swaps.
- For uncleared swaps/security-based swaps, counterparties to a dealer/MSP/MSSP will have the right to require the dealer/MSP/MSSP to hold initial margin in a segregated account. Any segregated margin must be maintained at an independent third-party custodian in a segregated account for the counterparty.

Some of the things we don't know

- What transactions will have to be cleared? Derivatives clearing organizations ("DCOs") must submit to the CFTC/SEC for approval lists of transactions they plan to clear. The CFTC and SEC are required to publish lists of transactions that should be cleared. All of those lists will probably include plain-vanilla transactions, but it is unclear how many more types of transactions will be included on the DCOs', the CFTC's, and the SEC's lists, and what happens if the DCOs' and the regulators' lists don't match up.
- How will the new capital and margin requirements affect market participants who are not dealers or MSPs/MSSPs? How will pricing and margin requirements be affected?
- What margin will be required for uncleared swaps? The Derivatives Act simply directs regulators to set such margin for dealers and MSPs/MSSPs to ensure the safety and soundness of the dealers or MSPs/MSSPs and to be appropriate for the risks associated with such swaps. It is also not clear if swaps/security-based swaps entered into before the effective date will be subject to the minimum margin requirements.
- What will the required segregated accounts look like? Will they be standardized agreements with custodial banks, or will they be hard-fought, one-off agreements each counterparty will have to negotiate with its dealers? Will the transaction pricing be less favorable if a counterparty requires a segregated account?
- What will the uncleared market look like? Will margin and capital requirements be set at levels that are so high as to make the uncleared market unaffordable/unworkable?
- What DCMs and SEFs will develop and what form will they take?

What we think might happen

- Plain-vanilla swaps will be cleared without affecting current margin levels significantly.
- Bespoke or structured swaps will not generally be cleared but will require higher margin. There may well be a period of significant dislocation in this market, as regulators, dealers, and non-dealer counterparties come to terms with just how difficult the task of analyzing risk and assigning margin and capital requirements really is. Portfolio margining, netting, hedge margining, and similar concepts will be very difficult to build into the non-standardized swap margining and collateralization models.
- Clearing platforms will be scrutinized by buy-side counterparties to ensure that collateral is segregated, can be ported to a solvent alternative counterparty, and is insulated from competing claims in bankruptcy (the so-called waterfall risk) as far as possible.
- The purchase or sale of a security-based swap that provides incidents of ownership comparable to direct ownership of the underlying equity security will likely trigger beneficial ownership reporting requirements, based upon rules to be written by the SEC.

Bank Dealer Push-Out and Volcker Rules

Some of the things we know

- Deposit-taking banks can continue to house swap desks that engage in hedging transactions, swaps involving interest rates or currencies, swaps involving several hard commodities (gold, silver, other forms of bullion, etc.), and cleared credit default swaps. Other swap activities (such as equity swaps, commodity swaps, and non-cleared credit default swaps) must move to a non-bank affiliate.
- The Volcker Rule limits the proprietary trading of swaps by banks and their affiliates. Please click here for the Ropes & Gray Alert examining the Volcker Rule—The Impact of Financial Reform: Banking, Corporate Governance, and Executive Compensation.

Some of the things we don't know

- Will the expense of separately-capitalized swap subsidiaries or limits under the Volcker rule lead banks to spinoff certain swap activities?

What we think might happen

- The push-out rule will not take effect for several years. The new rules become effective two years after the Derivatives Act, with an additional two-year transition period available for banks, with the possibility of a one-year discretionary extension period also available. That's forever in the derivatives market.
- As banks re-locate their swap desks, buy-side clients will evaluate carefully the creditworthiness and trading documentation for each new bank affiliate counterparty. New documentation and trading limits may be required.
- The spin-outs may well further constrain the non-standardized markets, since ready pools of capital may not be available to support dealing/market-making.

We continue to evaluate the impact of financial reform legislation, especially those changes that may affect the investment management, banking, hedge and private investment fund, private equity, and derivatives businesses. If you have questions concerning *Financial Reform Matters*, please contact any of the attorneys listed below or the Ropes & Gray attorneys with whom you regularly work:

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