

ClientAlert

Financial Markets Developments

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Dodd-Frank Wall Street Reform and Consumer Protection Act

The New Derivatives Regulatory Regime: Overview and Implications of the Wall Street Transparency and Accountability Act of 2010

Title VII ("Title VII") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act") addresses the regulatory reform of the over-the-counter ("OTC") derivatives market. It will radically change the way this market operates and affect how market participants interact by, among other things, imposing oversight of market participants and establishing new regulated entities. The stated principal aims of the legislative reform of this market are to reduce systemic and counterparty risk and to increase market transparency. The legislators seek to achieve these goals in a number of ways, including the forced and encouraged migration of OTC derivatives transactions onto regulated clearing exchanges, limitations on engaging in certain activities by banks and systemically important market participants, the registration and oversight of significant market participants and the obligation to report transaction information to both regulators and the market in a timely manner.

In this client alert, we address certain important reforms introduced by Title VII: the "swaps push out provision," the structure and division of market oversight by the Securities Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC;" each of the SEC and the CFTC is referred to herein as a "Commission"), the registration and regulation of dealers and significant market participants and the consequences of being a regulated dealer or significant market participant, including the heightened capital and margin, reporting and recordkeeping requirements, the central clearing and exchange trading requirements, the limitations on positions, collateral segregation and bankruptcy protection and the extraterritorial applicability of Title VII.

The text of Title VII provides, in many respects, only the framework for the new regulatory landscape. The contours and refinements of its operation and application must still be worked out, and this undertaking has been left to the regulatory agencies and the rulemaking process. The SEC, CFTC and prudential regulators have a great deal of work ahead of them, and it is further complicated by the stated requirement of ensuring inter-agency coordination and cooperation. The task is nothing short of monumental and they have relatively little time in which to accomplish what has been asked of them.

Derivatives markets are global in nature and the flight by market participants to less or differently regulated markets can happen relatively quickly, complicating the task of regulators as they seek to implement the requirements of Title VII. There is a pressing need for international coordination by the CFTC and the SEC with foreign regulatory



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agencies as the broad regulatory ideals agreed to at the summits of nations can often yield extreme divergences when “translated” into the specific text of legislation in jurisdictions around the world.

Most of the provisions of Title VII will become effective 360 days after the Act is signed into law. Each of the SEC and the CFTC, with some exceptions, is required also to finalize and publish the implementing regulations within 360 days of enactment. While we wait for these regulations to provide more clarity, all participants in the OTC derivatives market must prepare for what lies ahead. As the details of the framework are worked out in the months to come, and indeed, with the interpretation of the Act and regulations also impacting the implementation, years ahead, market participants will need to invest in understanding the new landscape and the implications of this radical transformation.

We have prepared, for reference only, a copy of the [Commodity Exchange Act](#) (the “CEA”), the [Securities Exchange Act of 1934](#) (the “Exchange Act”) and the [Securities Act of 1933](#) (the “Securities Act”) each as amended, modified or supplemented by Title VII. Please click on the name of the act to link to the copy.

I. What is the actual prohibition included in the “swaps push out provision” and what entities will be affected by its introduction?

One of the most controversial provisions of the Act, the “swaps push out provision,” originally proposed by Senator Blanche Lincoln, prohibits “Federal assistance” from being provided to any “swaps entity” (other than certain insured depository institutions) with respect to any swap, security-based swap or other activity of the swaps entity.² Key to the determination of whether the prohibition of this provision is applicable in a particular circumstance is a consideration of the terms “Federal assistance” and “swaps entity.” As more fully set out below, certain bona fide hedging by insured depository institutions will be exempt from the prohibition.³

Who is a “swaps entity” under the “swaps push-out provision” of Title VII?

■ A “swaps entity” means any swap dealer, security-based swap dealer, major swap participant or major security-based swap participant (each as defined below).⁴ While the scope of the terms “major swap participant” and “major security-based swap participant” will be determined pursuant to further regulation, swap dealers will essentially include banks and other financial institutions that make a market in derivatives.

- Excluded from the term “swaps entity” are any major swap participants or major security-based swap participants that are insured depository institutions. Therefore, an insured depository institution will only be a “swaps entity” if it is a swap dealer. In addition, “swaps entity” does not include any insured depository institution under the Federal Deposit Insurance Act or a covered financial company under Title II of the Act, which are conservatorships or receiverships or bridge banks operated by the Federal Deposit Insurance Corporation (“FDIC”).⁵
- A “swap dealer”⁶ or “security-based swap dealer”⁷ is defined as anyone who:
 - Holds itself out as dealer in swaps.⁸
 - Is a market maker in swaps.
 - Regularly engages in purchases and resales of swaps in the ordinary course of business.
 - Engages in activities commonly associated with a dealer or market maker.
- The term will not include a person that enters into swaps for such person’s own account and not as a part of regular business.⁹ A de minimis exemption from designation as a swap dealer may be granted by the relevant Commission.¹⁰
- The definition of “swap dealer” is qualified by a proviso (which is not in the definition of “security-based swap dealer”) that states that an insured depository institution will not be considered a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.
- A “major swap participant”¹¹ or a “major security-based swap participant”¹² means any person that is not a swap dealer and:
 - Maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC or SEC, as applicable, excluding positions (a) held for hedging or mitigating commercial risk or (b) maintained by any employee benefit plan for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.
 - Whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets.
 - Is a financial entity that is highly leveraged and maintains a substantial position in outstanding derivatives in any major swap category as determined by the CFTC or SEC, as applicable.

- The definition of “substantial position,” as applicable to the term “major swap participant,” is to be established by the CFTC and, as applicable to “major security-based swap participant,” by the SEC.¹³ This term will be set at a threshold determined to be prudent for the effective monitoring, management and oversight of entities that are systemically important or can significantly impact the financial system of the United States.
- In the case of major swap participants only, there is an exclusion from the definition for captive finance companies. This exclusion carves out from the definition of “major swap participant,” any entity primarily engaged in providing financing, and uses derivatives to hedge underlying currency and interest rate risk, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.
- It is perhaps an expression of legislative intent that resulted in the divergent treatment of swaps and security-based swaps in this exclusion. Although it is not certain, it is possible that the legislators specifically wished to allow captive finance companies to hedge rate and currency risk with swaps only and did not believe it to be relevant or appropriate to permit them to enter into security-based swaps.

What constitutes Federal assistance?

- “Federal assistance” is defined as the use of any advances from a Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act (this covers emergency lending powers), FDIC insurance or guarantees for the purpose of:
 - Making any loan to, or purchasing stock, equity interest, or debt obligation of, any swaps entity.
 - Purchasing the assets of any swaps entity.
 - Guaranteeing any loan or debt issuance of any swaps entity.
 - Entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity.¹⁴

What swap activities are permitted by swaps entities that receive Federal assistance?

- There is an exception to the “swaps push-out provision” for certain “insured depository institutions.” The prohibition against Federal assistance does not apply to an insured depository institution that limits its swap activities to hedging or other risk mitigating activities directly related to its activities or acting as a swaps entity for swaps involving rates or certain reference assets.¹⁵
- There is, however, a specific limitation to the permission granted to insured depository institutions when acting as a swaps entity. If the swap is a credit default swap (including credit default swaps on asset-backed securities), it must be cleared by a derivatives clearing organization (“DCO”) registered under the CEA or a clearing agency (together with DCOs, collectively referred to herein as “clearinghouses”) registered under the Exchange Act to allow the insured depository institution to qualify for the exception.
- It is not clear whether the applicability of these exceptions was intentionally limited to “insured depository institutions.” If this is the intent and this is not changed, it would appear that US branches of foreign banks, which would not be considered insured depository institutions, would not qualify for this exception. Moreover, the provision does not prohibit swap activities from being conducted by a swaps entity that is eligible for but not receiving Federal assistance.

Does the prohibition against Federal assistance apply to affiliated entities?

- The prohibition does not prevent an insured depository institution from having an affiliate which is a “swaps entity.” The insured depository institution may thus still receive Federal assistance, so long as (a) such insured depository institution is part of a bank holding company, or savings and loan holding company, supervised by the Federal Reserve and (b) the swaps entity affiliate complies with section 23A and 23B of the Federal Reserve Act and such other requirements of the CFTC or SEC, as appropriate, and the Board of Governors of the Federal Reserve System may determine to be necessary and appropriate.¹⁶
- Again, as this exception seems to be available only to “insured depository institutions,” US branches of foreign banks would likely not qualify.
- Providing sufficient capital to a separate swaps entity to meet the capital requirements imposed under Title VII and be acceptable as a derivatives counterparty will be prohibitively expensive, and will likely prevent all but the largest participants in the market to set up affiliated swaps entities.

When will the “swaps push-out” provision be effective?

- The prohibition against Federal assistance in the “swaps push out provision” will be effective two years after the effective date of the Act, which is 360 days after enactment. Therefore, the effective date of the “swaps push out provision” is almost three years after enactment. At that point, a transition period of up to 24 months (with a possible extension of up to one additional year) commences during which insured depository institutions must divest themselves of the swaps entity or cease the activities that require registration as a swaps entity.¹⁷
- The prohibition on Federal assistance will only apply to swaps entered into by the insured depository institution **after** the transition period.¹⁸
- Again, US branches of foreign banks appear to benefit neither from the limitation on the applicability of the prohibition to swaps entered into only after the transition period, nor from the transition period itself.

How does the Volcker Rule apply to swaps, even swaps that benefit from an exception to the swaps push out provisions?

- This is specifically addressed in Title VII. An insured depository institution is required to comply with the prohibition on proprietary trading as required by the Volcker Rule.
- For a copy of the White & Case LLP client alert on the Volcker Rule, please click [here](#).

II. How will regulatory oversight by the Commissions of the OTC derivatives market be structured?

Title VII divides the regulation of OTC derivatives between “swaps” on the one hand, which will be regulated by the CFTC, and “security-based swaps” on the other, which will be regulated by the SEC. Shared jurisdiction is provided over “mixed swaps” (*i.e.*, transactions which have characteristics of both security-based swaps and swaps). The exemptions from regulation introduced by the Commodity Futures Modernization Act of 2000 will be repealed upon the effectiveness of Title VII. The CFTC will also regulate “swap dealers” and “major swap participants” while the SEC will have primary regulatory responsibility for “security-based swap dealers” and “major security-based swap participants.”¹⁹ Given the potential for overlap of jurisdictional authority between the CFTC and the SEC, as well as with applicable prudential regulators, coordination is imperative. The risk of inconsistency in rules and in the interpretation of those rules is great. If this

inconsistency is significant enough, the uncertainty it introduces may reduce liquidity in certain markets and may cause product innovation to suffer.

Title VII requires the CFTC and the SEC to consult and coordinate, to the extent possible, with each other and with prudential regulators. The objective in the process is to ensure regulatory consistency and comparability to the extent possible. Joint rulemaking is mandated in some cases, as further discussed below. Title VII also requires the CFTC and the SEC to adopt rules and orders that treat functionally or economically equivalent products and certain regulated entities in a similar manner.

Title VII permits the CFTC and the SEC, individually, to collect necessary information relating to the swaps and security-based swaps markets, and issue reports with respect to any derivatives that either Commission determines is detrimental to the stability of, or participants in, a financial market.²⁰

If the CFTC or the SEC determines that the regulatory regime applicable to swaps or security-based swaps in a foreign country undermines the stability of the US financial system, the Commission, in consultation with the Treasury Secretary, is authorized to prohibit entities domiciled in such foreign country from participation in the United States in any swap or security-based swap activities.²¹

How will both the CFTC and the SEC promulgate rules? ²²

As noted above, in order to facilitate regulatory consistency and comparability, before any rulemaking by the CFTC with respect to swaps and by the SEC with respect to security-based swaps, the CFTC and SEC must consult and coordinate with the other Commission²³ and with the prudential regulators, to the extent possible.²⁴ The CFTC may not adopt regulations for the oversight of security-based swaps, and the SEC may not adopt regulations for the oversight of swaps, unless, in each case, specifically permitted under Title VII.²⁵ Neither the CFTC nor the SEC may engage in expedited rulemaking, as the Act requires at least a 30-day public comment period.²⁶

Title VII requires joint rulemaking by the CFTC and SEC, in consultation with the Board of Governors of the Federal Reserve System, with respect to further defining the terms “swap,” “security-based swap,” “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” “eligible contract participant” and “security-based swap agreement,”²⁷ and identifying the certain books and records required to be kept and maintained by registered swap data

repositories.²⁸ How these terms are defined will further refine how the Commissions will divide the scope of their respective regulatory jurisdictions over the market. Unless otherwise specified, the CFTC and/or SEC must individually adopt rules as required under Title VII within 360 days of enactment of the Act.²⁹ Title VII also requires the CFTC and the SEC to adopt rules and orders that treat functionally or economically equivalent products and certain regulated entities in a similar manner.

If either Commission believes that a final rule, regulation or order of the other agency conflicts with the authority granted to such other Commission under Title VII, the CFTC or SEC, as applicable, may obtain final review of such final rule, regulation or order in the United States Court of Appeals for the District of Columbia Circuit.³⁰ If the CFTC and the SEC are unable to jointly prescribe rules as required under Title VII, the Financial Stability Oversight Council (established under Title I of the Act) will resolve the dispute, at the request of either the CFTC or SEC.³¹

Will the CFTC and the SEC have exemptive authority?

It should be noted that Title VII does not provide for any general exemptive authority for the CFTC or the SEC, and each Commission will have exemptive authority only in cases where it is so expressly provided. This increases the potential for greater adverse repercussions from unintended consequences. As regulators will not be able to adjust the applicability of provisions that have or are perceived to have an unforeseen consequence, the market and its participants might be forced to wait until corrective legislative action is taken. That could take some time in certain circumstances, even years perhaps.

What is a “swap” and “security-based swap” under the Act?

- A “swap”³² is broadly defined to include most OTC derivatives, subject to the number of exclusions. A variety of types of swaps are specifically listed and categories of transactions are described in the definition, including the broad catch-all description of “an agreement, contract or transaction that is, or in the future becomes known to the trade as a swap.” Rates swaps, currency swaps, equity swaps, credit default swaps and commodity swaps are all included in the definition.
- Security-based swaps are excluded from the definition of “swap” and, therefore, from the CFTC’s jurisdiction. The following are also excluded from the definition of “swap:” futures traded on an exchange; futures that will be physically

settled; calls, options and straddles on securities that are subject to the Securities Act and the Exchange Act; foreign currency swaps entered into on an SEC registered exchange; transactions based on a security entered into for capital raising purposes; foreign exchange swaps; and foreign exchange forwards.³³ Also excluded is any sale of a nonfinancial commodity or any security for deferred shipment or delivery, so long as such transaction is physically settled.³⁴

- Foreign exchange swaps and forwards are to be considered “swaps” and subject to the CFTC’s jurisdiction, unless the Treasury Secretary makes a written determination that either or both should not be regulated as swaps and are not structured to evade the Act.³⁵ Notwithstanding such a determination by the Treasury Secretary, all foreign exchange swaps and forwards will be reported to a swap data repository (or the CFTC, if no swap data repository will accept such reporting), any swap dealer or major swap participant party to such transactions will be subject to business conduct standards, and the prohibitions on fraud and manipulation would also apply to contracts listed on or subject to the rules of a designated contract market or that are cleared by a derivatives clearing organization.
- The CFTC’s authority over retail foreign exchange transactions will not be impacted by any determination by the Treasury Secretary regarding whether foreign exchange swaps and forwards are “swaps.”

What is a security-based swap under the Act?

- A “security-based swap”³⁶ is defined as any agreement, contract or transaction that would be a swap under the CEA and is based on: a narrow-based security index, a single security or loan, or on the occurrence (or nonoccurrence or extent of occurrence) of an event relating to an issuer or issuers in a narrow-based security index (provided the event directly affect the issuer’s financial statements, financial condition or financial obligations). As a result of this definition, the SEC will have jurisdiction over single name credit default swaps or credit default swaps referencing narrow-based security indices, whereas the CFTC has been granted authority over credit default swaps referencing broad-based indices.
- The term excludes any agreement, contract or transaction that meets the definition of “security-based swap” only because it references, is based on, or settles through the transfer or delivery of an exempted security (other than any municipal security) under the Exchange Act, unless the nature of any such agreement, contract or transaction is of a put, call or other option.

III. How are significant market participants subject to regulation by the CFTC and/or the SEC?

- Title VII creates new categories of market participants that will be subject to registration with, and regulation by, the CFTC and/or SEC. In particular, swap dealers, security-based swap dealers, major swap participants and major security-based swap participants will be required to register with the CFTC and/or SEC, as applicable, and will be subject to heightened operational requirements. These requirements are discussed in detail below.
- An entity may be subject to registration with both the CFTC and the SEC depending on the extent and scope of its trading activities. A swap dealer in both swaps and security-based swaps, for instance, would be required to register as such with both Commissions.
- Additionally, Title VII expands the scope of definitions relating to certain market participants that are currently subject to registration and oversight. The definitions of “futures commission merchant,”³⁷ “commodity pool operator” and “introducing broker” have been expanded. If a swap dealer accepts money or other collateral in connection with cleared swap transaction, it will be required to register as a futures commission merchant, as well as being registered as a swap dealer.

IV. What are the consequences of being a registered swap dealer or major swap participant?

Swap dealers and major swap participants will be subject to capital and margin requirements. In addition, these entities will be subject to reporting, recordkeeping, business conduct standards and heightened duties and obligations, particularly when transacting with counterparties from certain enumerated classes.

How will capital and margin requirements be established?

Title VII imposes capital and margin requirements across all swap transactions, unless otherwise exempted. As explained below, how the requirements will be established will depend on whether or not the swap dealer or major swap participant is a bank.³⁸ In either case, margin requirements will include initial and variation margin requirements with respect to all derivatives not cleared by a clearinghouse. The Commissions and applicable prudential regulators will be required to consult at least annually regarding capital and margin requirements. Capital and margin standards for uncleared swaps will be established so as to help ensure the safety and soundness of the swap dealer or major swap participant, and be appropriate for the risk associated with uncleared swaps held by the swap dealer or major swap participant, meaning they will likely be higher than the

standards for cleared swaps. The particulars of these requirements are unknown at this time and will be established by rule and regulation. The capital and margin requirements will likely be high enough to provide market participants with a real incentive to clear swaps where possible.

- Banks which are swap dealers and major swap participants will be subject to capital and margin rules jointly adopted by the prudential regulators³⁹ in consultation with the CFTC and the SEC.⁴⁰
- Non-bank swap dealers and major swap participants will be subject to capital and margin requirements adopted by the CFTC or SEC, as applicable.⁴¹
- Futures commission merchants, introducing brokers and broker-dealers, will be subject to the stricter of the capital requirements applicable to such entity under the CEA and Exchange Act.⁴²
- Under Title VII, use of noncash collateral to satisfy the margin requirements will be permitted, if such use is consistent with preserving the financial integrity of markets trading swaps and the stability of the US financial system.
- Title VII does not specifically provide for an exemption from the margin requirements for counterparties exempt from the clearing requirements (i.e., end-users), but legislators have expressed that the intention is not for such counterparties to be subject to the margin requirements. However, the increased capital and margin requirements for swap dealers and major swap participants will likely result in higher costs for their counterparties, particularly in the case of uncleared derivatives.
- The Act does not prohibit the retrospective application of capital and margin requirements established pursuant to Title VII on existing transactions. Regulators may choose to apply such requirements prospectively.

What are the applicable reporting requirements for uncleared swaps?

- Swaps not accepted for clearing by a clearinghouse must be reported to either a swap data repository, or if no swap data repository will accept a reporting of the swap, to the CFTC or the SEC, as applicable.⁴³ Such reports must be provided within the time period established by rule or regulation.
- Swaps entered into prior to the enactment of the Act are to be reported to a swap data repository or to the CFTC or SEC, as appropriate.
- Additional recordkeeping and transaction reporting requirements are applicable to derivatives exempt from clearing, as prescribed by the CFTC or SEC, as applicable.⁴⁴

What are the recordkeeping and business conduct standards imposed upon swap dealers and major swap participants?

- Title VII imposes operational standards on swap dealers and major swap participants, including requirements to keep and maintain such books and records in such form and for such time periods as may be prescribed by the CFTC or SEC, as applicable, maintain daily trading records and all related records and audit trails.
- Title VII further requires large swap traders to keep books and records of any cash or spot transactions, or positions in, inventories of, and purchase and sale commitments of any related commodity traded on or subject to the rules of any board of trade.⁴⁵
- Each swap dealer and major swap participant must also conform with business conduct standards adopted by the relevant Commission. These standards address many requirements (including counterparty eligibility verification, disclosure requirements (i.e., risks, material incentives, trade valuation), back office standards and other requirements as determined by the relevant Commission to be appropriate in the public interest and for the protection of investors).

Will swap dealers and major swap participants be subject to any heightened duties?

Title VII imposes a heightened duty upon swap dealers and major swap participants as established by the relevant Commission when facing or acting on behalf of a “Special Entity,” which is defined as (a) a Federal agency; (b) a State, State agency, city, county, municipality or other political subdivision of a State; (c) any employee benefit plan (as defined in section 3 of ERISA); (d) any governmental plan (as defined in section 3 of ERISA); or (e) any endowment, including organizations described in section 501(c)(3) of the Internal Revenue Code.⁴⁶ The duties vary depending upon the relationship with the Special Entity and include those set out below.

- Acting as an advisor to a Special Entity:
 - A swap dealer that acts as an advisor to a Special Entity will have a duty to act in the best interests of the Special Entity, and shall make reasonable efforts to obtain such information as necessary to make a determination that the recommended derivatives transaction is in the best interest of the Special Entity.

- Entering into a transaction with a Special Entity:
 - A swap dealer or major swap participant that enters into a derivatives transaction with a Special Entity must have a reasonable basis to believe that the Special Entity has a qualified, independent advisor, and the swap dealer or major swap participant must make a disclosure to the Special Entity as to the capacity in which it is acting.

The above duties do not apply to transactions initiated by the Special Entity on an exchange or swap execution facility, or in which the identity of the Special Entity is not known to the swap dealer or major swap participant.

V. What are the new clearing requirements?⁴⁷

Parties in the OTC derivatives market have generally privately negotiated the terms of their agreements, including collateral arrangements, and managed counterparty risk on a bilateral basis. In the wake of the financial crisis, legislators have looked to central clearing as the way to mutualize risk that resulted from the multitude of bilateral arrangements and require central clearing for swaps, subject to certain specific exceptions. The hope is a reduction in systemic risk through the “interposition” in what was a bilateral arrangement of a substantially capitalized entity, a central clearinghouse. Once a swap is cleared through a clearing platform, each party to the original bilateral transaction no longer faces the other, but instead each has a contract with the interposed clearinghouse. The clearinghouse acts as the buyer to every seller, and the seller to every buyer. The parties are exposed solely to the clearinghouse. As a result, the parties are no longer concerned with the ability of the original counterparty to perform its obligations under the swap. The clearinghouse is required to manage this risk and will do so by establishing collateral and margin requirements.

Central clearing should not be viewed as a panacea, however. There are many issues with a transition of this size, and the clearinghouse, if improperly regulated, may actually increase systemic risk. A multitude of clearinghouses may also reduce the benefits of multilateral netting, and collateral costs for some participants may increase above current levels.

Title VII mandates central clearing of most derivatives transactions by either a registered or exempted DCO, in the case of swaps, or a clearing agency, in the case of security-based swaps.⁴⁸ To avoid a race to the bottom, and to perhaps riskier, less liquid, contracts by clearinghouses eager to gain market share, legislators have required that derivatives transactions which may be offered for clearing by clearinghouses be approved by the CFTC or the SEC,

as applicable. In considering whether to allow a contract to be cleared, the Commissions must consider many factors, including the outstanding notional exposure, trading liquidity and adequacy of pricing data, the operational and support infrastructure to clear and the effect on the mitigation of systemic risk.

The requirement for clearing can be stated simply as follows—in general, Title VII requires clearing of all derivatives that are offered for clearing by a clearinghouse and that have been approved for clearing by the CFTC or SEC, as applicable, unless the end-user exemption applies.

Generally, a clearinghouse will be required to prescribe that all derivatives it clears, with the same terms and conditions, are economically equivalent and will be offset within the clearinghouse, and will also be required to report to the CFTC and/or SEC, as applicable, all derivatives transactions submitted for clearing.⁴⁹ Title VII also requires the clearing of transactions executed bilaterally or on unaffiliated markets on a nondiscriminatory basis. The CFTC and the SEC will have one year from the date of enactment of the Act to issue regulations with respect to a DCO and a clearing agency's submission for review of any derivatives transaction that it seeks to accept for clearing, and the CFTC and the SEC will also promulgate rules in order to prevent evasion from the clearing requirements. Additionally, each Commission must, on an ongoing basis, review derivatives or any group, category or type of derivatives to determine if certain derivatives should be required to be cleared.⁵⁰

What are the exemptions from mandatory clearing?⁵¹

There are effectively only two exemptions from the clearing requirement: the end-user exemption and an exemption in the event no clearinghouse offers the swap for clearing.

- The end-user exemption:
 - Title VII exempts a swap or security-based swap from the clearing requirement if one of the counterparties (i.e., an end-user) (a) is not a financial entity (as defined below); (b) is using such derivatives transaction to hedge or mitigate commercial risk; and (c) notifies the CFTC or SEC, as applicable, how it generally meets its financial obligations associated with the uncleared swap.
 - “Financial entity” is defined to mean (a) a swap dealer or major swap participant; (b) a person predominantly engaged in activities that are in the business of banking or financial in nature, as defined in the Bank Holding Company Act; (c) a commodity pool as defined in the CEA or a private fund as defined in the Investment Advisers Act of 1940, or (d) an employee benefit plan.

- This is an elective exemption on the part of the end-user, which nevertheless may require that an uncleared swap be cleared. The end-user may also select the clearing platform on which to clear the swap.
- An affiliate of an end-user may also benefit from the exemption if the swap is entered into to hedge the commercial risk of the qualifying affiliated end-user, and so long as such affiliate is not a swap dealer or major swap participant or one of the other enumerated types of entities.
- Any end-user that is an issuer of securities registered under the Securities, Act or is a reporting company under the Exchange Act, must have obtained approval from the appropriate committee (such as an audit committee) of the decision not to clear a swap that is otherwise offered for clearing.
- Mandatory exemption:
 - Title VII provides for a mandatory exemption from the clearing requirements if no clearinghouse will accept the swap for clearing.
 - Additionally, in order to reduce clearing systemic risk, DCOs cannot be compelled to accept the counterparty credit risk of another clearing organization.⁵² There does not, however, seem to be a comparable provision applicable to clearing agencies for security-based swaps.

Are the CFTC and/or SEC vested with additional discretion with respect to clearing requirements?⁵³

- The CFTC and the SEC are each authorized to stay a mandatory clearing requirement upon application by a counterparty to a derivatives transaction or on the Commission's own initiative.
- The CFTC is additionally authorized to exempt small banks, savings associations, farm credit institutions and credit unions from the clearing requirements.

Is the clearing requirement retroactive?

- Swaps not meeting any exemption, but entered into prior to the date of enactment of the Act, will not be required to be cleared if reported within 180 days to a swap data repository⁵⁴ or the CFTC or SEC, as appropriate.⁵⁵

What are the public reporting requirements applicable to cleared swaps?

Under Title VII, each of the CFTC and the SEC is required to adopt rules and regulations relating to real-time public reporting of swap transaction data, including price and volume information. Title VII specifies that “real-time” reporting means reporting of the required information “as soon as technologically practicable.”

- The CFTC or SEC, as applicable, will require real-time public reporting for:

- Swaps subject to mandatory clearing.
- Swaps exempt from clearing pursuant to the end-user exemption.
- Swaps not subject to mandatory clearing, but which are cleared at a clearinghouse.

VI. What are the new requirements with respect to exchange trading?

A swap that is required to be cleared must also be traded on a board of trade designated as a contract market under Section 5 of the CEA, or executed on a swap execution facility that is either registered or exempt from registration.⁵⁶ A security-based swap that is required to be cleared must also be traded on an exchange or executed on a security-based swap execution facility that is registered with the SEC or exempt from registration.⁵⁷ As mentioned above, in addition to reducing systemic risk, legislators also aim to provide greater transparency to the market and facilitate the dissemination of pricing data by mandating trading on trade execution platforms and requiring real-time trade information reporting.

What are the exemptions from the exchange trading requirements?

- Swaps not made available by any board of trade or (security-based) swap execution facility for trading, or exempt from the clearing requirements, are exempt from the exchange trading requirement.

VII. What are the requirements relating to segregation of collateral?

Title VII requires collateral segregation for cleared swaps, essentially replicating the same treatment of collateral as is applicable to futures transactions, and gives the end-user counterparty the option to require segregation of collateral that is delivered to a swap dealer and major swap participant in connection with an uncleared swap. There likely will be an effect on pricing if end-users require such collateral segregation under uncleared swaps.

- Cleared derivatives:
 - Segregation of collateral is required, and all collateral must be treated as belonging to the customer and not commingled with other assets or re-hypothecated, with narrow exceptions.

- Additionally, any person who accepts any money, securities or other assets on behalf of a customer to margin, guarantee or secure cleared derivatives, must be registered with the CFTC as a futures commission merchant, in the case of swaps, or with the SEC as a broker, dealer or security-based swap dealer, in the case of security-based swaps.⁵⁸

- Uncleared derivatives:

- Swap dealers and major swap participants must notify counterparties at the start of a transaction of their right to require segregation.
- At the request of a counterparty, a swap dealer or major swap participant must segregate and maintain collateral in a separate account for the benefit of such counterparty. The provisions with respect to segregation of funds do not, however, apply to variation margin or preclude arrangements with respect to the investment of such segregated funds into investments as permitted by the relevant commission.⁵⁹

VIII. What is a swap-execution facility?

A swap execution facility is a new entity created by the legislation, and it remains somewhat unclear as to exactly what type of facility will satisfy the requirements of the definition. As with many other provisions of Title VII, the specific details relating to swap execution facilities are to be established by rules or regulation of the CFTC or SEC, as applicable. It is hoped that such regulations will consider and reflect how participants currently transact in OTC derivatives markets. We believe that so long as a trade execution platform can accomplish the goals of price discovery and transparency, it should not be excluded from being a swap execution facility.

- A “swap-execution facility” is defined as a facility trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, including any trading facility that facilitates the execution of security-based swaps between persons and is not a designated contract market.⁶⁰
- A “security-based swap-execution facility” is defined as a trading system or platform in which multiple participants have the ability to execute or trade security-based swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, including any trading facility that facilitates the execution of security-based swaps between persons and is not a national securities exchange.⁶¹

- Any facility for the trading or processing of derivatives must be registered with the CFTC as a designated contract market or a swap-execution facility (for swaps) or with the SEC as a national securities exchange or a security-based swap execution facility (for security-based swaps), regardless of its registration status with the other Commission.⁶² A swap-execution facility can be exempted from registration by the CFTC if the CFTC finds that it is subject to comparable, comprehensive regulation by the SEC, a prudential regulator, or the appropriate home country regulator.⁶³ The SEC may similarly exempt from registration a security-based swap execution facility if the SEC finds that it is subject to comparable, comprehensive regulation by the CFTC.⁶⁴
- Swap-execution facilities will also be subject to requirements relating to, among other things, recordkeeping and maintenance of information. These facilities must also comply with applicable requirements relating to trade monitoring and processing and ensuring financial integrity of transactions.⁶⁵

IX. What is the extraterritorial reach of Title VII?

Title VII provides that the CEA provisions introduced by Title VII will not apply to swap activities occurring outside the US, so long as such swap activities do not have a direct or significant connection with, or effect on, US activities or commerce, and do not contravene rules or regulations established by the CFTC to prevent evasion of any provisions of the CEA as enacted by Title VII.⁶⁶

With respect to security-based swaps, provisions of the Exchange Act added by Title VII will not apply to any person transacting a business in security-based swaps outside the United States, unless such person transacts the business in contravention of rules or regulations established by the SEC to prevent evasion of any provisions of the Exchange Act as enacted by Title VII.

As noted above, the CFTC and the SEC will each have the authority, in certain cases, to prohibit entities domiciled in a foreign country from participating in derivatives activities in the United States. Foreign entities that do operate in the United States and function as swap dealers or major swap participants will likely be subject to the same requirements as domestic entities, such as registration and operational requirements, although it is unclear whether and how the activities of such foreign entities that occur outside the United States will be impacted by Title VII. To resolve such issues and establish applicable regulations, the CFTC and the SEC will need to coordinate with foreign regulatory agencies.

X. Was the preemption of state gaming and bucket shop laws affected?

Currently under the CEA, swaps are preempted from being subject to “gaming” and “bucket shop” state statutes. The Act preempts such application in the case of security-based swaps between eligible contract participants; however, no similar provision is included with respect to swaps. If this was the intent of the legislators, the Act will create significant legal uncertainty with respect to the application of such state statutes.

Conclusion

Title VII provides, in many respects, only the framework for derivatives regulation, and regulators have been entrusted with completing the details and implementing the legislation. Given that, they generally have only one year in which to coordinate and establish such regulations for Title VII. Once such regulations are in place, compliance by market participants will likely be time-consuming and costly and will require significant changes to their internal compliance systems and procedures, and the costs of entering into new transactions will also likely increase. For example, while Title VII will likely produce improved efficiencies and result in decreased costs for certain transactions that become commoditized, it may also result in higher costs for “bespoke,” uncleared transactions due to higher capital and margin requirements for their swap dealer or major swap participant counterparties.

Market participants will also need to review agreements currently in effect, as well as current practices, in light of Title VII. Notably, unless specifically reserved in the applicable swap agreement, no provision of Title VII or regulation enacted pursuant to Title VII is to constitute a termination event, force majeure, illegality, increased costs, regulatory change or similar event that would permit a party to terminate, renegotiate, modify, amend or supplement one or more transactions under such swap agreement. As a result, parties may find themselves caught between legislatively mandated obligations on one hand, and contractual obligations that provide otherwise on the other. Participants should be aware of and be prepared for such potential inconsistencies.

1. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, H.R. 4173, 111th Cong. (2010). Title VII itself is entitled “Wall Street Transparency and Accountability” and may be cited as the “Wall Street Transparency and Accountability Act of 2010.” References herein to Title VII are references to the provisions of this title of the Act.
2. § 716.
3. § 716(a).
4. § 716(b)(2)(A).
5. § 716(g).
6. § 721(a)(21) (codified as § 1a(49) of the CEA).
7. § 761(a)(6) (codified as § 3(a)(71) of the Exchange Act).
8. Unless otherwise specified, the terms “swaps” and “security-based swaps” for ease of reference are collectively referred to herein as “swaps,” and other terms, such as major swap participant or major security-based swap participant, which vary depending on the use of the words “swap” or “security-based swap,” are referenced collectively using only the word “swap.”
9. § 721(a)(21) (codified as § 1a(49)(C) of the CEA); § 761(a)(6) (codified as § 3(a)(71)(C) of the Exchange Act).
10. § 721(a)(21) (codified as § 1a(49)(D) of the CEA); § 761(a)(6) (codified as § 3(a)(71)(D) of the Exchange Act).
11. § 721(a)(16) (codified as § 1a(33) of the CEA).
12. § 761(a)(6) (codified as § 3(a)(67) of the Exchange Act).
13. § 721(a)(16) (codified as § 1a(33)(B) of the CEA); § 761(a)(6) (codified as § 3(a)(67)(B) of the Exchange Act).
14. § 716(b)(1).
15. § 716(d). The reference assets covered by this provision are those that qualify as permissible for investment by a national bank under the National Bank Act (at 12 U.S.C. 24). These include loans, foreign currency, coins, bullion (which includes gold and silver), U.S. government securities and agency securities, and certain debt securities.
16. § 716(c).
17. § 716(h).
18. § 716(e).
19. § 712(a)(1); § 712(a)(2).
20. § 714.
21. § 715.
22. § 712.
23. § 712(a)(1); § 712(a)(2).
24. § 712(a)(6).
25. § 712(b)(1); § 712(b)(2).
26. § 745(b) (codified as § 5c(c)(3)(C) of the CEA).
27. § 712(d)(1).
28. § 712(d)(2)(B).
29. § 712(e).
30. § 712(c)(1)(A).
31. § 712(d)(3).
32. § 721(a)(21) (codified as § 1a(47) of the CEA).
33. § 721(a)(21).
34. § 721(a)(21).
35. In making any such determination, the Treasury Secretary is required to consider: (a) whether mandatory trading and clearing of foreign exchange swaps and forwards would create systemic risk or threaten U.S. financial stability, (b) whether foreign exchange swaps and forwards are already subject to comparable regulation, (c) the extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, (d) the extent of adequate payment systems and (e) the use of a potential exemption of foreign exchange swaps and forwards to evade otherwise applicable regulatory requirements.
36. § 761(a)(6) (codified as § 3(a)(68) of the Exchange Act).
37. § 721(a)(13). A “futures commission merchant” is an individual, association, partnership, corporation or trust that is engaged in soliciting or in accepting orders for the purchase or sale of a commodity or future delivery, a security futures product, a swap, certain agreements described in § 2(c)(2) of the CEA, certain commodity options, or any leverage transaction under § 19 of the CEA; or is acting as a counterparty in certain agreements or transactions under § 2(c)(2) of the CEA and in connection therewith accepts any money, securities or property to margin, guarantee or secure any trades or contracts that result or may result therefrom.
38. § 731 (codified as § 4s(e) of the CEA); § 764(a) (codified as § 15F(e) of the Exchange Act).
39. Depending on the particular entity, the “prudential regulator” is the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Farm Credit Administration or the Federal Housing Finance Agency. § 761(a); § 721(a)(17).
40. § 731 (codified as § 4s(e)(1)(A) of the CEA); § 764(a) (codified as § 15F(e)(1)(A) of the Exchange Act).
41. § 731 (codified as § 4s(e)(1)(B) of the CEA); § 764(a) (codified as § 15F(e)(1)(B) of the Exchange Act).
42. § 731 (codified as § 4s(e)(3)(B)(ii) of the CEA); § 764(a) (codified as § 15F(e)(3)(B)(ii) of the Exchange Act).
43. § 729 (codified as § 4r(a)(1) of the CEA); § 766 (codified as § 13A(a)(1) of the Exchange Act).
44. § 729 (codified as § 4r(a)(3) of the CEA); § 766 (codified as § 13A(a)(3) of the Exchange Act).
45. § 730 (codified as § 4t(a)(2)(b) of the CEA); § 737(a).
46. § 731 (codified as § 4s(h)(2) of the CEA); § 764(a) (codified as § 15F(h)(2) of the Exchange Act).
47. §§ 723, 727, 729, and 730.
48. § 723(a)(3) (codified as § 2(h) of the CEA); § 763(a) (codified as § 3C(a) of the Exchange Act).
49. § 723(a)(3) (codified as § 2(h)(1)(B) of the CEA); § 763(a) (codified as § 3C(a)(2) of the Exchange Act).
50. § 723(a)(3) (codified as § 2(h)(2)(A) of the CEA); § 763(a) (codified as § 3C(b)(1) of the Exchange Act).
51. § 723(a)(3); § 763(a).
52. § 725(h) (codified as § 5b(f)(1) of the CEA).
53. § 723(a)(3); § 763(a).
54. A (security-based) swap data repository is defined as any person that collects and maintains information or records with respect to transactions, positions in, or terms and conditions of, third party (security-based) swap transactions for the purpose of providing a centralized recordkeeping facility for (security-based) swaps.
55. § 723(a)(3) (codified as § 2(h)(6)(A) of the CEA); § 763(a) (codified as § 3C(f)(1) of the Exchange Act).

- 56. § 723(a)(3) (codified as § 2 (e) of the CEA).
- 57. § 763(a) (codified as § 3C(h)(1)(B) of the Exchange Act).
- 58. § 724(a) (codified as § 4d(f)(1) of the CEA; § 763(d) (codified as § 3E(a) of the Exchange Act).
- 59. § 724(c) (codified as § 4d(f)(2)(A) of the CEA; § 763(d) (codified as § 3E(b) of the Exchange Act).
- 60. § 721(a)(21) (codified as § 1a(50) of the CEA).
- 61. § 761(a)(6) (codified as § 3(a)(77) of the Exchange Act).
- 62. § 733(codified as § 5h(a) of the CEA); § 763(c) (codified as § 3D(a) of the Exchange Act).
- 63. § 733 (codified as § 5h(f) of the CEA).
- 64. § 763(c) (codified as § 3D(e) of the Exchange Act).
- 65. § 733 (codified as § 5h(b) of the CEA); § 763(c) (codified as § 3D(b) of the Exchange Act).
- 66. § 722. Note this does not include security-based swaps.

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