Dodd-Frank Title VII: Reforms for the Swaps Marketplace

On July 21, 2010, President Obama signed into law the Dodd-Frank Act ("Act"), which institutes sweeping reforms across the financial services industry.[1] Title VII of the Act, titled "Wall Street Transparency and Accountability," pertains to derivatives and contains several important provisions, some of which will have implications for entities operating as bank holding companies. The title focuses on regulation of over-the-counter ("OTC") swaps markets and security-based swap markets, and distinguishes between "swaps," which under the new regulatory framework are regulated by the Commodity Futures Trading Commission ("CFTC"), and "security-based swaps," now under the purview of the Securities and Exchange Commission ("SEC") (collectively, "Commissions").[2] "Mixed-swaps" are subject to dual jurisdiction, in consultation with the Board of Governors of the Federal Reserve System.[3] This memorandum summarizes some of the key provisions of Title VII of the Act, including those:

- distinguishing between swaps and security-based swaps and splitting CFTC and SEC jurisdiction between the two categories
- requiring registration
- placing restrictions on the ability of insured depository institutions to engage in swap transactions subject to certain exceptions, and allowing affiliates of insured depository institutions to engage in swap activity if they meet specified conditions
- providing the Commissions the authority to prescribe minimum capital and margin requirements for non-banks, and the prudential regulators the authority to do the same with regard to banks
- creating a clearing framework

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1 The Dodd-Frank Act is available at http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173.

2 Section 712. Title VII of the Act uses the term "swap" broadly, encompassing most types of OTC derivatives; among those transactions included in the term are future occurrence-dependent transactions, interest rate swaps, equity and equity index swaps, debt and debt index swaps, credit and credit default swaps, credit spreads, and commodity swaps. *See* Section 721. The Act defines a "security-based swap" as any swap that "is based on — (I) an index that is a narrow-based security index . . . (II) a single security or loan . . . or (III) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer." Section 761. Title VII repeals those provisions of the Gramm-Leach-Bliley Act and the Commodity Futures Modernization Act of 2000 that limited the SEC's authority to regulate security-based swaps, and adds regulation of security-based swaps to the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)). *See* Sections 761-64, 766-68.

3 Section 721. A mixed swap is a security-based swap that "also is based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence." Sections 721, 761.

Unless otherwise provided in the Act, its provisions will take effect on the later of 360 days after the statute's enactment or, to the extent a provision requires rulemaking, no sooner than 60 days after the publication of the final rules or regulations pertaining to that provision.

I. Registration, Capital and Margin Requirements (Sections 731, 764)

Title VII of the Act makes it unlawful for any person to act as a swap dealer or security-based swap dealer or as a major swap participant or major security-based swap participant unless the person is registered as such with the relevant commission.[4] Swap/security-based swap dealers and major swap/security-based swap participants must register no later than one year after the date of the statute's enactment.[5]

The Act requires the CFTC and SEC to adopt rules for registered swap/security-based swap dealers and major swap/security-based swap participants. The Commissions' authority to promulgate such rules is limited only in that the Commissions may not "impose prudential requirements" on swap/security-based swap dealers or major swap/security-based swap participants "for which there is a prudential regulator."

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[4] The Act defines "swap dealer" 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 as an 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, provided, however, in no event shall an insured depository institution be considered to be 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." Section 721. A "security-based swap dealer" is defined similarly, except without the exclusion for an insured depository institution entering into a swap with a customer. *See* Section 761. Both definitions further create a "de minimis exception," declaring that the commission shall exempt from designation as a swap/security-based swap dealer "an entity that engages in a de minimis quantity of swap [or security-based swap] dealing in connection with transactions with or on behalf of its customers." Sections 721, 761. A "major swap participant" is defined as "any person who is not a swap dealer" and "(i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding— (I) positions held for hedging or mitigating commercial risk; and (II) positions maintained by an employee benefit plan . . . for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan; (ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; <u>or</u> (iii) (I) is a financial entity that 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 (II) maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission." Sections 721 (emphasis added). The definition of "major security-based swap participant" in the Act is substantially similar to that of "major swap participant," except that the latter excludes from its definition "an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 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." *See* Sections 721, 761. The term "substantial position," as well as other terms potentially vital to determining whether an entity is a major swap/security-based swap participant (or a swap/security-based swap dealer), are subject to later definition by the CFTC and SEC, in conjunction with the Board of Governors. *See* Sections 712, 721, 761.

[5] These persons are also required to "make such reports as are required by the Commission by rule or regulation regarding the transactions and positions and financial condition of the registered swap [or security-based swap] dealer or major swap [or security-based swap] participant," and to keep books and records. Sections 731, 764.

The Act also provides the CFTC and SEC, as appropriate, the authority to prescribe minimum capital requirements and minimum initial and variation margin requirements for swap/security-based swap dealers and major swap/security-based swap participants that are *not* banks. With regard to those that are banks, the Act hands the responsibility of setting minimum capital and margin requirements to the banks' respective prudential regulators, in consultation with the CFTC and SEC. In particular, the margin requirements required to be imposed by the Act relate to "all swaps [or security-based swaps] that are not cleared" by a registered derivatives clearing organization or clearing agency (as margin requirements pertaining to cleared swaps or security-based swaps are set by the relevant derivatives clearing organization or clearing agency).[6]

The Act provides the Commissions and prudential regulators with some guiding principles for setting capital and margin requirements, directing them to impose requirements that "help ensure the safety and soundness of the swap [or security-based swap] dealer or major swap [or security-based swap] participant" and that are "appropriate for the risk associated with the non-cleared swaps [or security-based swaps] held as a swap [or security-based swap] dealer or major swap [or security-based swap] participant." On the issue of prescribing margin requirements, the Act further instructs the Commissions and prudential regulator, as appropriate, to "permit the use of noncash collateral, as the regulator or the Commission determines to be consistent with . . . preserving the financial integrity of markets trading swaps [or security-based swaps]" and "preserving the stability of the United States financial system." The Act does not define "noncash collateral," ostensibly leaving further clarification of this term to the appropriate regulators. Finally, the Act requires the CFTC, the SEC, and the prudential regulators to consult periodically (at least annually) on minimum capital requirements and minimum initial and variation margin requirements and, "to the maximum extent practicable, [to] establish and maintain comparable" minimum capital and margin requirements, including the use of noncash collateral, for swap dealers and major swap participants and for security-based swap dealers and major security-based swap participants.

It remains to be seen how the CFTC, SEC, and prudential regulators will exercise their rulemaking authority. Because the Act only provides general rulemaking guidance to the CFTC, SEC, and prudential regulators and places few limitations on these regulatory bodies' rulemaking authority, the rules adopted by these bodies may have far-reaching effects on banks and bank holding companies.

II. Clearing and Trading Requirements (Sections 723, 763)

With few exceptions, the Act subjects swaps and security-based swaps to mandatory clearing. The Act requires swaps and security-based swaps to be cleared by a "derivatives clearing organization" or clearing agency, respectively, so long as the clearing organization or agency accepts the swap/security-based swap for clearing and the CFTC or SEC determines that such a swap/security-based swap is required to be cleared. Under the Act, the CFTC and SEC not only review submissions of the clearing organizations and agencies with regard to those swaps/security-based swaps they plan to accept for clearing, but also review swaps and security-based swaps on their own initiative in order to determine which categories of swaps/security-based swaps should be required to be cleared. With limited exceptions, swaps subject to the clearing requirement must be traded on either a "board of trade designated as a contract market" or a "swap execution facility" registered with the CFTC, and security-based swaps subject to the clearing requirement must be traded on either a national securities exchange or a "security-based swap execution facility" registered with the SEC.

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[6] For more on the clearing requirements imposed by Title VII of the Act, see Section II.

Swaps and security-based swaps entered into before the date of the statute's enactment are not subject to the Act's clearing requirements, though they must be reported to a registered swap/security-based swap data repository or the relevant commission. The Act's clearing requirements are also inapplicable to swaps/security-based swaps where one of the counterparties thereto "(i) is not a financial entity; (ii) is using swaps [or security-based swaps] to hedge or mitigate commercial risk; and (iii) notifies the Commission . . . how it generally meets its financial obligations associated with entering into non-cleared swaps [or security-based swaps]." A "financial entity," in this regard, includes swap/security-based swap dealers, major swap/security-based swap participants, commodity pools, private funds, employee benefit plans, and people "predominantly engaged in activities that are in the business of banking or financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956."[7] In other words, counterparties that engage in swaps to hedge or mitigate their own commercial risk are exempt from the Act's clearing requirements.

Affiliates of a person who qualifies for one of the listed exceptions "(including affiliate entities predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the person)" likewise qualify for the exception if they, in acting on behalf of the person or as agents, use the swap/security-based swap "to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity." Certain affiliates, however, may not avail themselves of the statutory exemptions from the Act's clearing requirements; these include swap/security-based swap dealers, major swap/security-based swap participants, certain issuers, commodity pools, and bank holding companies owning consolidated assets of more than $50 billion.

Those swap/security-based swap transactions not subject to the Act's clearing requirements are also exempt from the Act's trading requirements. Additionally, the trading requirements are inapplicable, in the case of swaps, "if no board of trade or swap execution facility makes the swap available to trade," and in the case of security-based swaps, "if no exchange or security-based swap execution facility makes the security-based swap available to trade."

III. Collateral Segregation Requirements (Sections 724, 763)

Under the Act, a person may not accept any money, securities, or property, "from, for, or on behalf of a swaps customer to margin, guarantee, or secure a swap cleared by or through a derivatives clearing organization" without first registering as a futures commission merchant with the CFTC. Similarly, a person may not accept any money, securities, or property "from, for, or on behalf of a security-based swaps customer to margin, guarantee, or secure a security-based swap cleared by or through a clearing agency" without first registering as a broker, dealer, or security-based swap dealer with the SEC. Futures commission merchants, brokers, dealers, and security-based swap dealers are required to segregate "all money, securities, and property of any swaps [or security-based swaps] customer received to margin, guarantee, or secure" a cleared swap or security-based swap; the Act generally prohibits commingling of such assets (though there are certain exceptions in the Act, and the respective Commissions are authorized to create additional exceptions allowing for commingling).

With regard to uncleared swaps, the Act provides that swap/security-based swap dealers and major swap/security-based swap participants are required to segregate the funds or other property supplied to margin,

7 The Act also gives the Commissions authority to determine whether to exclude, from treatment as a "financial entity" small banks, savings associations, farm credit system institutions, and credit unions.

guarantee, or secure the obligations of the counterparty (other than variation margin payments) and comply with any related rules or regulations, if the counterparty so requests. At the beginning of the swap/security-based swap transaction, the swap/security-based swap dealer or major swap/security-based swap participant must notify its counterparty of its right to request that its funds be segregated.

IV. Real-Time Public Reporting Requirements (727, 763)

The Act requires the CFTC and SEC "to provide by rule for the public availability" of swap transaction and pricing data, and of security-based swap transaction, volume, and pricing data. Specifically, the rule obligates each respective commission to require real-time public reporting of swaps/security-based swaps that are subject to the mandatory clearing requirement, swaps/security-based swaps that are not subject to the mandatory clearing requirement but are cleared at a registered derivatives clearing organization or clearing agency, and swaps/security-based swaps that are required to be cleared but are not cleared. Additionally, with regard to swaps that are not cleared but are reported to a swap/security-based swap data repository or the commission, the commission must require real-time public reporting "in a manner that does not disclose the business transactions and market positions of any person." The Act defines "real-time public reporting" as the reporting of data relating to a swap or security-based swap transaction, "including price and volume, as soon as technologically practicable after the time at which the swap [or security-based swap] transaction has been executed."

V. Ban on Proprietary Trading (Sections 619, 716)

With certain exceptions, Section 619 of the Act, known as the Volcker Rule, prohibits "a banking entity" from engaging in "proprietary trading" or acquiring or retaining "any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or a private equity fund," and Section 716 later reiterates that "[a]n insured depository institution shall comply with [this] prohibition on proprietary trading in derivatives."[8] Proprietary trading "means engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies," the SEC, and the CFTC may, by rule, determine. A "trading account," in turn, is "any account used for acquiring or taking positions in the securities and instruments . . . principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts" determined by the relevant Federal banking agencies, the SEC, and the CFTC.

Section 619 enumerates certain activities that the appropriate Federal banking agencies, the SEC, and the CFTC may determine are permitted. Among these activities are "[t]he purchase, sale, acquisition, or disposition or securities or other instruments . . . in connection with underwriting or market-making-related activities, to the extent that any such activities . . . are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties"; "[r]isk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the

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8 The Act defines a "banking entity" as "any insured depository institution . . ., any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity." Section 619.

specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings"; and "[t]he purchase, sale, acquisition, or disposition of securities and other instruments . . . on behalf of customers." However, the Act makes clear that no activity may be deemed permitted if it would involve or cause a material conflict of interest between the banking entity and its clients, customers, or counterparties; would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; would pose a threat to the safety and soundness of the banking entity; or would threaten the financial stability of the United States.

VI. Limitation on Federal Assistance of Swaps Entities (Section 716)

The Act prohibits "Federal assistance" from being provided "to any swaps entity with respect to any swap, security-based swap, or other activity of the swaps entity."[9] The term "swaps entity" is defined as any swap/security-based swap dealer or major swap/security-based swap participant that is registered under the Commodity Exchange Act or the Securities Exchange Act of 1934. Explicitly excluded from categorization as a "swaps entity," however, is any major swap/security-based swap participant that is an insured depository institution.[10] This implies that an insured depository institution will only be deemed a swaps entity if it is a swap/security-based swap dealer. The Act further provides that an insured depository will not be subject to the prohibition on "Federal assistance" so long as it limits its swap/security-based swap activities to "[h]edging and other similar risk mitigating activities directly related to the insured depository institution's activities" and "[a]cting as a swaps entity for swaps or security-based swaps involving rates or reference assets that are permissible for investment by a national bank" under the National Bank Act.[11] With regard to the latter limitation, the Act specifies that "[a]cting as a swaps entity for credit default swaps, including swaps or security-based swaps referencing the credit risk of asset-based securities . . . shall not be considered a bank permissible activity . . . unless such swaps or security-based swaps are cleared" by a derivatives clearing organization or a clearing agency that is registered or exempt from registration.

With regard to affiliates of insured depository institutions, the Act states that the prohibition on Federal assistance "does not apply to and shall not prevent an insured depository institution from having or establishing an affiliate which is a swaps entity, as long as such insured depository institution is part of a bank holding company, or savings and loan holding company, that is supervised by the Federal Reserve and such swaps entity affiliate complies with sections 23A and 23B of the Federal Reserve Act [regarding Relations with Affiliates and

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[9] "Federal assistance" includes "the use of any advances from any 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, Federal Deposit Insurance Corporation insurance or guarantees for the purpose of— (A) making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity; (B) purchasing the assets of any swaps entity; (C) guaranteeing any loan or debt issuance of any swaps entity; or (D) entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity."

[10] Also excluded from "the term 'swaps entity'" is "any insured depository institution under the Federal Deposit Insurance Act or a covered financial company under title II which is in a conservatorship, receivership, or a bridge bank operated by the Federal Deposit Insurance Corporation."

[11] Under the paragraph marked "Seventh" of 12 U.S.C. 24, national banks are granted "all such incidental powers as shall be necessary to carry on the business of banking," and thus may invest in various assets, including promissory notes, drafts, bills of exchange, and "other evidences of debt"; foreign currency, coin, and bullion; loans on personal security; and investment securities. National banks may not, however, deal in equity securities.

Restrictions on Transactions with Affiliates, respectively] and such other requirements” as may be determined by the CFTC, SEC, or Board of Governors of the Federal Reserve System.

The prohibition on Federal assistance will take effect two years after the Act becomes effective. The Act requires the appropriate Federal banking agency, in consultation with the CFTC or SEC, as appropriate, to allow the insured depository institutions subject to the prohibition a transition period of up to two years “to divest the swaps entity or cease the activities that require registration as a swaps entity.” The Act further permits the appropriate regulatory bodies to extend this transition period for an additional year.

Section 716 of the Act also dictates that a bank or bank holding company may not become a swaps entity unless it conducts its swap/security-based swap activity “in compliance with such minimum standards set by its prudential regulator as are reasonably calculated to permit the swaps entity to conduct its swap or security-based swap activities in a safe and sound manner and mitigate systemic risk.” The statute lists various factors for “the prudential regulator for a swaps entity” to consider in prescribing rules, including the expertise and managerial strength of the swaps entity and its financial strength.

VII. Position Limits (Sections 733, 735, 737, 763)

Under Section 737 of the Act, the CFTC is required to establish limits on the amount of positions, other than bona fide hedge positions, that a person may hold “with respect to contracts of sale for future delivery or with respect to options on the contracts or commodities traded on or subject to the rules of a designated contract market,” or their economic equivalent. The CFTC must set limits on the number of positions a person may hold per month, as well as the aggregate number of positions a person may hold for all months. In setting limits, the CFTC is required to strive to diminish excessive speculation, deter market manipulation, ensure sufficient market liquidity for bona fide hedgers, and prevent the disruption of the underlying market’s price discovery function. The CFTC must also attempt to ensure that “trading on foreign boards of trade in the same commodity will be subject to comparable limits and that any limits to be imposed by the Commission will not cause price discovery in the commodity to shift to trading on the foreign boards of trade.” The CFTC is authorized to carve out exemptions from the position limits it creates.

The Act, in Section 763, requires the SEC to limit the size of positions a person may hold in any security-based swap. The Act further authorizes the SEC to adopt “hedge exemption provisions” and otherwise to exempt any category of persons, security-based swaps, or transactions from its position limits. The SEC may also require a person to aggregate positions in any security-based swap and either (1) “any security or loan or group of securities or loans on which such security-based swap is based, which such security-based swap references, or to which such security-based swap is related,” or (2) “any security or group or index of securities [or any other instrument related thereto], the price, yield, value, or volatility of which, or of which any interest therein, is the basis for a material term of such security-based swap.”

In addition to the powers granted to the CFTC and the SEC with regard to establishing position limits, the Act bestows upon swap execution facilities and boards of trade the authority to adopt, for each of their contracts, “position limitations or position accountability for speculators” necessary to decrease the potential threat of market manipulation or congestion. The swap execution facilities and boards of trade, however, may not set position limitations at levels higher than those established by the Commissions.

VIII. Forthcoming Regulation Regarding Conflict of Interest (Section 726, 765)

Sections 726 and 765 contain provisions providing for future rulemaking to address potential conflicts of interest. These provisions direct the CFTC and SEC, as appropriate, to adopt rules "which may include numerical limits on the control of, or the voting rights with respect to," derivatives clearing organizations that clear swaps, clearing agencies that clear security-based swaps, swap/security-based swap execution facilities or boards of trade or national securities exchanges that post or make available for trading swaps/security-based swaps, by a bank holding company owning consolidated assets of at least $50 billion, a non-bank financial company supervised by the Board of Governors, swap/security-based swap dealers, major swap/security-based swap participants, or their associates or affiliates.

The purpose of these rules would be to "improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest" with regard to business conducted between swap/security-based swap dealers or major swap/security-based swap participants and derivatives clearing organizations, clearing agencies, contract markets, national exchanges, or swap/security-based swap execution facilities in which the dealers or participants have "a material debt or equity investment." In promulgating the rules, the CFTC and SEC are instructed to "consider any conflicts of interest arising from the amount of equity owned by a single investor, the ability to vote, cause the vote of, or withhold votes entitled to be cast on any matters by the holders of the ownership interest, and the governance arrangements of any derivatives clearing organization that clears swaps, or swap execution facility or board of trade designated as a contract market that posts swaps or makes swaps available for trading."

IX. Conclusion

The provisions of Title VII of the Act create a new regulatory framework for the derivatives market and impose many novel requirements and limitations on entities engaged in swap/security-based swap activities, including bank holding companies. However, given the broad rulemaking authority the Act grants to the CFTC and SEC (and occasionally to other regulators), the full impact Title VII will have on these entities will only be known after the Commissions adopt rules and regulations implementing Title VII's various provisions.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Yafit Cohn at 212.701.3089 or ycohn@cahill.com; or Theodore B. Lacey at 212.701.3669 or tlacey@cahill.com.

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