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Derivative Reform Enacted Into Law

Sweeping derivative reform legislation contains momentous changes to the way swaps and security-based swaps are regulated and reported.

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On July 21, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) was signed into law by President Obama. Title VII of the Act, titled the Wall Street Transparency and Accountability Act of 2010, contains significant changes to the ways in which derivatives are regulated. Some important aspects of the new regulations are summarized below.

Regulation of Swaps and Security-Based Swaps

The Act will regulate the over-the-counter derivatives market by doing the following:

(i) Defining the terms "swap" and "security-based swap" broadly, to include almost any agreement or transaction where payments under the agreement or transaction are determined by reference to the value or level of an underlying asset, index, or quantitative measure; and

(ii) Imposing clearing, exchange trading, capital, margin, registration, reporting, recordkeeping, and business conduct requirements on such agreements or transactions and certain parties thereto.

A swap under the Act includes, among other things, puts, calls, caps, floors, collars, and options on rates, currencies, commodities, securities, debt, indices, quantitative measures, interests, or property. It also includes transactions where payments are dependent upon the occurrence, nonoccurrence, or extent of an occurrence of an event associated with a financial, economic, or commercial consequence.

Finally, the term includes transactions (such as typical swap transactions) that provide for the exchange of payments based upon the value or level of rates, currencies, commodities, securities, debt, indices, quantitative measures, interests, or property, and transfer financial risk associated with the change in value of such underlier without conveying an ownership interest in the underlier. Permutations of and options on all of the foregoing also constitute swaps. Foreign exchange swaps and forwards (terms which are limited to the exchange of two different currencies) are considered to be swaps, unless the Secretary of the Treasury determines that they should not be regulated under the Act and are not structured to evade the Act.

Security-based swaps are swaps related to securities, loans, narrow-based securities indices, and events relating to issuers of securities affecting the financial condition thereof, such as credit default swaps.

Stable value contracts are not swaps or security-based swaps and will not be considered to be such until the U.S. Commodity Futures Trading Commission (CFTC) and U.S. Securities and Exchange Commission (SEC) have conducted a study to determine whether such contracts should be swaps or security-based swaps and promulgated rules in respect of such contracts.

There are only a few other exclusions from the expansive definition of swap and security-based swap. Generally, those exclusions relate to listed futures; commodity or security transactions that are intended to be physically settled; options subject to the Securities Act and Securities and Exchange Act (for example, listed options); listed foreign currency options; agreements providing for the purchase of securities registered under the Securities Act and the Securities Exchange Act; debt securities; agreements entered into by issuers as part of the capital-raising process; and transactions with the Federal Reserve, the federal government, or certain federal agencies.

The Act sets forth regulatory reform goals and contains only a few specifics as to how it will be implemented. The Act gives the CFTC and the SEC (and to some extent, applicable banking authorities) broad authority to promulgate rules relating to the implementation of the legislation. Generally, the CFTC will regulate swaps and participants in that market and the SEC will regulate security-based swaps and participants in that market. Transactions that contain both swaps and security-based swaps, known as mixed swaps, will be subject to regulation by both the CFTC and SEC. The two agencies are required to coordinate and harmonize their respective regulation and, in certain cases, are required to engage in joint rulemaking.

Regulation of Certain Swap Parties

Certain swap parties will be subject to enhanced regulation under the Act. Clearing, exchange trading, capital, margin, registration, reporting, recordkeeping, and business conduct requirements will be imposed upon swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants (collectively, covered participants).

Swap dealers and security-based swap dealers will include those persons who hold themselves out as dealers, make markets in swaps or security-based swaps, or regularly enter into swaps or security-based swaps in the ordinary course of business for their own account. A person may be a swap dealer or security-based swap dealer with respect to a single type or multiple types of swap activities. Insured depository institutions are not swap dealers to the extent they offer to enter into a swap with a customer in connection with originating loans to that customer.

Major swap participants and major security-based swap participants include the following:

(i) Those who maintain substantial positions in swaps or security-based swaps or major categories of those swaps, excluding positions for hedging or mitigating commercial risk and positions held by an ERISA plan for the primary purpose of hedging or mitigating risk;

(ii) Those whose outstanding swaps create substantial exposure that could have serious adverse effects on the financial stability of the banking system or financial markets; and

(iii) Highly leveraged financial entities that are not subject to capital requirements established by a federal banking agency and that maintain a substantial position in outstanding swaps in any swap category.

A person may be a major swap participant or major security-based swap participant with respect to a single type or multiple types of swap activities.

The CFTC and SEC will define the term "substantial position" by regulation in a manner prudent for the effective oversight of entities that are systemically important or can significantly impact the financial system. When setting the definition of substantial position, the commissions are permitted to consider a person's relative position in cleared and uncleared swaps and the value of collateral held against exposures.

The CFTC and SEC will be able to regulate covered participants in a variety of ways. In addition to imposing clearing, exchange trading, capital, margin, registration, reporting, recordkeeping, and business conduct requirements upon covered participants, the CFTC and SEC will be able to impose prudential requirements upon covered participants other than banks. Prudential requirements for banks will be established by the applicable banking authorities.

Swap transactions effected by insurance companies will not be considered to be insurance and will not be able to be regulated as such. Therefore, such swap transactions will be regulated by the CFTC or SEC, as applicable, rather than state insurance commissioners.

Clearing and Exchange Trading Requirements

Under the Act, the CFTC and SEC are required to adopt rules establishing criteria for determining those swaps and security-based swaps that are required to be cleared. Generally, the Act makes it unlawful to enter into a swap or security-based swap that is required to be cleared, unless the swap is submitted for clearing. The Act gives the CFTC and SEC the ability to issue temporary stays from this clearing requirement in order to review the terms of the applicable swap or security-based swap.

If one party to a swap or security-based swap is not a financial entity (a term that includes swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, commodity pools, certain private funds, ERISA plans, and banking entities), and that party (a commercial end user) is using such swap to hedge or mitigate commercial risk and notifies the relevant commission how it generally meets its financial obligations associated with noncleared swaps, then such swap does not have to be cleared. The commercial end user may, however, choose to clear the swap. If the commercial end user is a public company, an appropriate committee of the board of directors must approve any election *not* to clear the swap. Swaps that are not cleared are subject to reporting and recordkeeping requirements.

If a swap or security-based swap is not required to be cleared and occurs between a covered participant and a counterparty that is not a covered participant, the counterparty that is not a covered participant has the option to require the clearing of the swap or security-based swap and to select the derivatives clearing organization at which the same will be cleared.

If a swap or security-based swap is required to be cleared, it may not be traded except on a board of trade designated as a contract market, on an exchange, or through a swap execution facility, unless the same does not make the swap or security-based swap available for trading.

It is unlawful for any person, other than an eligible contract participant (a term intended to identify those persons who should be sophisticated based on their regulated status or asset size), to enter into a swap, unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market. Similarly, unless they are registered under the Securities Act, security-based swaps may not be offered or sold to persons who are not eligible contract participants.

Registration, Reporting, Recordkeeping, and Business Conduct

Covered participants will have to register as such with the CFTC or SEC or both, as applicable, in accordance with rules and on forms to be prescribed by the CFTC or SEC. Registered parties will have to satisfy reporting, recordkeeping, and business conduct requirements. Business conduct requirements will include, among other things, (i) a duty to disclose information about material risks and characteristics of the swap, material incentives or conflicts of interest relating to the swap, and daily marks for the swap; (ii) a duty to communicate in a fair and balanced manner; (iii) a duty to verify that the counterparty to a swap is an eligible contract participant; and (iv) a duty to conform to other rules to be established by the commissions including those relating to fraud, manipulation, abusive practices, supervision, and position limits.

Additionally, when a covered participant offers or enters into a swap with a federal agency, state, state agency, city, county, municipality, political subdivision, ERISA plan, governmental plan, or endowment (collectively, special entities), it will have additional enhanced duties. If a covered participant acts as an advisor to a special entity, then it may not defraud the entity and has a duty to act in the best interests of the special entity. Additionally, the covered participant must make reasonable efforts to obtain information to make a reasonable determination that any swap recommended by the covered participant is in the best interests of the special entity. That investigation includes obtaining information relating to financial status, tax status, and investment or financing objectives.

When not acting as an adviser to a special entity, a covered participant must disclose in writing the capacity in which it is acting, and have a reasonable basis to believe that the special entity has an independent representative that (i) has sufficient knowledge to evaluate the transaction and risks; (ii) is not subject to statutory disqualification; (iii) is independent of the covered participant; (iv) undertakes a duty to act in the best interests of the counterparty it represents; (v) makes appropriate disclosures; (vi) provides written representations to the special entity regarding the fair pricing and the appropriateness of the transaction; and (vii) in the case of employee benefit plans subject to ERISA, is an ERISA fiduciary.

Capital and Margin

Under the Act, the appropriate banking regulator will set minimum capital, initial margin and variation margin levels for banks. Capital levels must be greater than zero for banks. The CFTC and SEC are authorized to set minimum capital, initial margin and variation margin requirements for nonbank covered participants that are as strict as or stricter than those set by the banking regulators for banks. Substantially higher capital levels will be required for uncleared swaps or security-based swaps as compared to similar swaps or security-based swaps that are cleared through a clearinghouse.

Swaps with commercial end users are not exempt from the margin requirements of the Act.

Pre-existing Contracts

Swaps and security-based swaps that are entered into before the enactment of the Act, and remain in effect after enactment, must be reported to a registered swap data repository or the CFTC or SEC, as applicable. The Act has two provisions that are arguably in conflict and that discuss the period within which to comply with the reporting requirement for pre-existing contracts. One provision requires reporting no later than 540 days after enactment, while the other provision may require reporting as early as 120 days after enactment (although the commissions are given flexibility to set the period of time in this case). If pre-existing swaps and security-based swaps are reported within the 540-day period described in the preceding sentence, they will be exempt from the clearing requirements of the Act. Pre-existing swaps do not appear to be exempt from the Act's margin requirements (although they were so exempted in early drafts of the legislation). Swaps entered into on or after the enactment of the Act must be reported to a swap data repository or the relevant commission no later than the later of 450 days after enactment or such time as the commission may prescribe. Swaps entered into after enactment of the Act but before clearing requirements are promulgated are exempt from clearing requirements if reported as described in the preceding sentence. Another reporting provision of the Act, which may be in conflict with the foregoing from a timing perspective, requires the reporting of swaps that are not accepted for clearing by a derivatives clearing organization.

Unless specifically reserved in a swap, neither the enactment of the Act nor any requirement of the Act or amendment made by the Act shall constitute a termination event, force majeure, illegality, increased costs, regulatory change or similar event under a swap that would permit a party to terminate, renegotiate, modify, amend or supplement one or more transactions under the swap. This may cause significant concerns for covered participants who have not so reserved such rights and may experience increased costs in maintaining a swap or security-based swap transaction subsequent to the enactment of the Act.

Effectiveness and Rulemaking

The Act generally takes effect on the later of 360 days after enactment and, to the extent a provision of the Act requires rulemaking, no less than 60 days after publication of the final rule or regulation implementing the provision. Unless otherwise provided, the CFTC and SEC are required to promulgate rules within 360 days of enactment.

Exemptive Authority

The Act prohibits both the CFTC and the SEC from granting exemptions under their respective applicable statutes from the provisions of the Act, unless expressly authorized to do so. There are no expressly authorized exemptions (other than for stable value contracts) with respect to the definitions of swap, security-based swap, swap dealer, security-based swap dealer, major swap participant and major security-based swap participant, although the CFTC and SEC are authorized to adopt rules with respect to certain components of the definitions pertaining to covered participants. The CFTC and SEC are, however, given the authority to further define certain terms for the purpose of including transactions that have been structured to evade the Act.

Push-out of Bank Swap Activities

The Act prohibits providing any federal assistance to certain entities (swap entities) with respect to any swap, security-based swap, or other activity of that swap entity. Federal assistance includes using any advances under a Federal Reserve credit facility or discount window (that does not have broad-based

eligibility) or providing FDIC insurance or guarantees for the purpose of (i) making loans to or purchasing equity or debt of the entity; (ii) purchasing assets of the entity; (iii) guaranteeing any loan or debt of the entity; or (iv) entering into any assistance arrangement (including tax breaks), loss-sharing arrangement, or profit-sharing arrangement with the swap entity. Swap entities include any covered participant that is registered under the Commodity Exchange Act or the Securities Exchange Act but do not include any major swap participant or major security-based swap participant that is an insured depository institution.

An insured depository institution is also subject to the prohibitions on federal assistance described above, unless the depository institution limits its swap activities to (i) hedging and mitigating risks related to its activities and (ii) acting as a covered participant with respect to rates or reference assets that are permissible for investment by a national bank. Credit default swaps, including swaps referencing the credit risk of asset-backed securities, are not considered to be a permissible bank activity unless they are cleared. The prohibition against federal assistance only applies to swaps and security-based swaps entered into after the end of a transition period that may be as long as five years after enactment (with the possibility of an additional one-year extension in certain circumstances).

Position Limits

The Act requires the CFTC to establish aggregate position limits for futures, exchange traded swaps, and swaps that perform a significant price discovery function. Additionally, with respect to physical commodities, the CFTC may establish position limits (other than with respect to bona fide hedge positions) that may be held by any person with respect to futures or options on futures or commodities. In establishing position limits, the CFTC must attempt to ensure that trading on foreign boards of trade in the same commodity will be subject to comparable limits and that any limits imposed by the CFTC will not cause price discovery in the commodity to shift to foreign boards of trade. Position limits may include spot-month, single-month, and all-month aggregate limits.

The Act also directs the SEC to establish limits on the size of positions in any security-based swap that may be held by a person. Hedging exemptions from such limits may be granted by the SEC. For purposes of such position limits, the SEC may require aggregation of positions in security-based swaps and related underliers and instruments. Additionally, the SEC may direct self-regulatory organizations to adopt position limits.

Large Trader Reporting

The Act makes it unlawful for any person to enter into a swap determined by the CFTC to perform a significant price discovery function in excess of amounts established by the CFTC, unless the person properly reports the swap and related positions in underliers in a manner to be prescribed by the CFTC and the person keeps relevant records. Similarly, the SEC may require persons effecting transactions in security-based swaps and related underliers and instruments to report their aggregate positions. Although the authority given the SEC to require such reporting technically applies to all persons, the heading of the relevant provision in the statute indicates that the intention of the Act was to require reporting from large traders only.

Exchange Act Reporting

For purposes of Sections 13 and 16 under the Securities Exchange Act, a person will be deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap

if the SEC determines (in consultation with bank regulators and the Secretary of Treasury) that the purchase and sale of the security-based swap provides incidents of ownership comparable to direct ownership of the equity security.

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact the author, **Thomas D'Ambrosio** (212.309.6964; tdambrosio@morganlewis.com), or either of the following Morgan Lewis attorneys:

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