

## Swap Clearing and Other Requirements in the New Financial Regulation Law (Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010)

As we described in our July 21, 2010, client alert outlining the new financial regulation law, Title VII of the new law extensively regulates the “over-the-counter” derivatives market by requiring that most swaps be cleared and executed through a regulated facility and imposing margin and capital requirements on uncleared swaps executed by swap dealers or major swap participants. This Client Alert outlines various rules of Title VII. The practical significance of these rules will be largely determined by regulations to be written by various federal regulators.

### What Swaps Need to Be Cleared?

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All swaps (other than those qualifying for the commercial hedging exemption described below) that the CFTC determines should be cleared. Derivatives clearing organizations (DCOs) are required to submit to the CFTC information about swaps they clear to assist the CFTC’s decision, but the CFTC may decide that any swap must be cleared. The SEC will determine the clearing requirements for security-based swaps. For simplicity, this Client Alert focuses on swaps and the CFTC rather than security-based swaps and the SEC. In general, parallel requirements exist for security-based swaps. The term swaps refers to all forms of over-the-counter derivatives.

- *What if a party to the swap is hedging commercial risk?*

The swap clearing requirement does not apply to non-“financial entities” that hedge or mitigate commercial risk if such entity notifies the CFTC as to how the end-user generally meets its obligations under uncleared swaps. The CFTC will presumably issue regulations specifying what constitutes adequate notification.

“Financial entity” includes any swap dealer, major swap participant, private fund, pension plan, or other entity predominantly engaged in (i.e. 85% of its revenues derive from) financial activities as broadly defined in the Bank Holding Company Act to include banking, insurance, and securities activities. An affiliate of a non-“financial entity” (such as a finance subsidiary) may qualify for the commercial hedging exception from clearing for a swap used to hedge or mitigate the commercial risk of the non-“financial entity” with which it is affiliated. However, if the affiliate fits the definition of major swap participant (described below), the exemption would not be available.

- *What if no DCO will clear the swap?*

If no DCO will accept a swap for clearing, it is not required to be cleared.

- *What is a swap dealer or major swap participant?*

A swap dealer (SD) includes any bank, broker, or other party that regularly trades swaps with customers or other dealers. A major swap participant (MSP) is any party that has a substantial position in swaps other than for hedging

or mitigating commercial risk or has a volume of counterparty exposures that could have a serious adverse effect on financial stability or the stability of the banking system. This could include, for example, a hedge fund that is not a dealer in swaps. To more broadly cover highly leveraged swap counterparties, the definition of MSP also includes any party with a substantial position in swaps (even if for commercial hedging) if that party is both highly leveraged “relative to the amount of capital it holds” and is not subject to capital requirements imposed by bank regulators. This could affect finance subsidiaries and other affiliates of commercial entities that are highly leveraged even if their swap exposures are not large enough to endanger the stability of the banking system. As explained in the previous section, such affiliates would not qualify for the commercial hedging exemption from clearing.

Both an SD and an MSP can be so designated for a specific type of swap rather than for all swaps. This means such a party might qualify as a commercial hedger for some types of swaps, but not others. As a practical matter, banks and other prominent SDs will likely be SDs in all cases.

- *Does the clearing requirement cover a party that is not an SD or MSP?*

Yes. Unless a party meets the commercial hedging exception, the swap must be cleared. If a party is unable or unwilling to comply with a DCO's clearing requirements for a swap, the party will need to use the traditional futures exchanges for hedging. In any case, the existing rules for eligible contract participants (as modified by Title VII) determine whether a party is eligible to execute a swap off a traditional futures exchange.

### What Are the Rules for Executing a Swap That Needs to be Cleared?

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A swap that must be cleared must also be executed on a swap execution facility (SEF) unless no SEF will accept the swap for execution.

### What Are the Margin Rules for Swaps Not Cleared Through a DCO?

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Any uncleared swap executed by an SD or MSP will be subject to margin rules to be specified by the CFTC or by the appropriate federal banking regulator if the SD or MSP is a bank. Although Senate supporters of the new law have stated commercial users should not be subject to margin requirements under the language of the law, commercial users will presumably execute their swaps with SDs or, to a lesser extent, MSPs. Unless the appropriate regulators somehow find margin is not required from the commercial user in such swaps, those trades will be subject to whatever margin requirements the regulators impose. Given the controversy in this area, it is possible the regulators will limit the margin posting requirement on the side of the commercial user or at least be expansive in their powers to permit the use of non-cash collateral.

An SD or MSP that receives initial margin as collateral under a margin arrangement with a non-SD/non-MSP counterparty must segregate the initial margin collateral with a third party custodian if requested by the counterparty. If the initial margin is not segregated, the SD or MSP must provide the counterparty with quarterly reports on the maintenance of the collateral.

## What Are the Capital Requirements for Swaps Not Cleared Through a DCO?

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Regulators are required to establish capital requirements for SDs and MSPs to cover uncleared swaps. The SDs or MSPs cost in maintaining such capital will presumably affect the cost of swaps entered into with commercial hedgers. Current capital requirements for swap (which presumably are lower than what regulators will require under the new law) are understood to affect swap pricing.

## What Are the Reporting Requirements for Swaps Not Cleared Through a DCO?

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All uncleared swaps must be reported to a swap repository or the CFTC. If the uncleared swap is between an SD and an MSP, the SD must report. If it is between an SD or MSP and a commercial party, the SD or MSP counterparty must report. In all other cases, the 2 parties must decide which will report.

## Does the New Law Impose Fiduciary Duties on Swap Dealers?

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No. The Senate bill passed in May included a controversial provision that swap dealers automatically assumed fiduciary obligations to any governmental entity, pension plan, retirement plan, or endowment by entering into a swap with such a party. The final law distinguishes between whether SDs or MSPs advise such "special entities" or merely enter into a swap with the special entity.

When either an SD or an MSP offers to enter into a swap with a special entity it must comply with duties the CFTC will prescribe to demonstrate that the SD or MSP has a reasonable basis to believe the special entity is represented by an "independent representative." This independent representative is intended to provide the special entity with market information about the swap and information about its risks. SDs are also specifically required to disclose to special entities in writing the role they are performing in the swap transaction.

SDs and MSPs advising special entities about a swap will be subject to special fraud and anti-manipulation rules. An SD acting as an advisor to a special entity for a swap it enters into with that special entity is required to act in the best interests of the special entity and to make reasonable efforts to obtain information necessary to determine whether the swap it offers is in the best interests of the special entity.

## What is the Section 716 Or "Push Out" Provision?

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Section 716 of the new law states that no SD or MSP may be FDIC insured, make a regular borrowing from the Federal Reserve's discount window, or receive other "federal assistance" unless an exception is available. Without exceptions, this provision would have prevented banks from being swap dealers.

Through a complicated set of exceptions, banks will be able to continue to be swap dealers for interest rate and currency swaps and all other swaps that either (A) involve "rates or reference assets" that are permissible national bank investments or (B) otherwise hedge risks arising out of banking activities. This will include credit default swaps on investment grade securities. Section 716, however, requires that any such CDS bought or sold by a bank must be cleared through a DCO.

Banks that enter into swaps not covered by these exceptions (such as CDS on non-investment grade securities or energy derivatives) will need to conduct those SD activities through a separately capitalized affiliate.

## Effective Dates

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The Section 716 “push out” provision takes effect after 2 years. After Section 716 becomes effective, federal banking regulators can establish up to a 2 year transition period for a bank SD to move the relevant activities to an affiliate or cease such activities altogether. The clearing, reporting, margin, and other requirements described in this Client Alert take effect when the enacting regulations are issued by the CFTC or (for security-based swaps) by the SEC. Margin, capital, and other requirements for banks (and their affiliates other than those regulated by the SEC or CFTC) acting as SDs or MSPs will be established by the appropriate federal banking regulator for each bank and such affiliates.

If you would like to discuss any of the issues addressed in this Client Alert, please contact Kenneth Marin at 212.655.2510 or [kmarin@chapman.com](mailto:kmarin@chapman.com) or the Chapman attorney with whom you usually work, or visit us online at [chapman.com](http://chapman.com).

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