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DERIVATIVES AND ASSET MANAGEMENT

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Dodd-Frank Wall Street Reform and Consumer Protection Act: Implications for Derivatives

Introduction

The "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "**Act**"), as agreed and reported by the House-Senate conference committee and approved by the House of Representatives, will, if enacted, profoundly change the way derivative products, and the market participants that use them, will be regulated. The derivatives title of the Act, itself to be known as the Wall Street Transparency and Accountability Act of 2010, will, among other things:

- Subject a broad category of derivatives to regulation by the Commodity Futures Trading Commission ("**CFTC**") and/or Securities and Exchange Commission ("**SEC**");
- Require clearing and exchange trading of many derivatives;
- Impose additional margin and capital requirements on uncleared derivatives;
- Establish a comprehensive framework for the registration and regulation of dealers and "major" non-dealer market participants;
- Prohibit proprietary trading in certain derivative instruments by some regulated financial institutions; and
- Prohibit certain swap market participants from receiving federal assistance, a change that will force many (but not all) derivatives activities to be "pushed out" of insured banks into separately capitalized affiliates.

These changes are far-reaching and will affect a wide range of market participants, even those not directly subject to regulation under the new regime. Several changes, particularly the restrictions on proprietary trading, the "push-out" requirement and the scope of end-user exemptions from clearing and other requirements, have been controversial throughout the House and Senate debates over the legislation and the conference process. The legislation leaves many of the details of the new framework to be determined by regulations to be adopted by the SEC, CFTC and other financial regulators.

While a full picture of the impact of the new legislation will thus have to wait for the implementing rulemakings, a number of implications for different types of market participants are apparent.

Implications for Financial Institutions

Financial institutions will face significant new regulation and, in some cases, new prohibitions on dealing in derivatives, including the following:

- The so-called "Volcker Rule" will limit proprietary trading in derivatives by banks and certain other financial institutions.
- As a condition of receiving certain federal assistance, including access to the discount window, insured banks will be required to move many derivatives activities into a separately capitalized affiliate (with limited exceptions for hedging activities by the bank and derivatives involving certain financial asset classes).
- Financial institutions will likely need to register with the CFTC as swap dealers and with the SEC as security-based swap dealers.
- Transactions will have to be submitted for clearing, if required by regulators and if a clearing organization will accept such transactions.
- Transactions subject to the clearing requirement will have to be executed on an exchange or swap execution facility, if a trading facility will accept such transactions.
- Financial institutions will be subject to increased capital and margin requirements.
- Financial institutions will be subject to new business conduct requirements in dealing with their counterparties and customers.
- Financial institutions will have to segregate customer margin in connection with cleared derivatives and offer initial margin segregation to customers in non-cleared transactions.

Implications for Hedge Funds and Similar Entities

Hedge Funds and similar trading vehicles will face additional requirements, depending on the scope of their derivative activities, including the following:

- Funds that meet certain trading thresholds may be required to register with the CFTC as "major swap participants" and/or with the SEC as "major security-based swap participants."
- If registered, funds will be subject to capital, margin, business conduct and other requirements.
- Funds trading swaps will also be treated as commodity pools, and managers and trading advisors may be subject to regulation as commodity pool operators and commodity trading advisors.
- Whether or not funds are major swap participants, their derivatives transactions will in many cases have to be submitted for clearing and executed on an exchange or swap execution facility, as with transactions by financial institutions.
- Additional margin requirements will be imposed on derivatives, although dealer counterparties will be required to offer initial margin segregation options.

Implications for Corporate End-Users

Corporate end-users of derivatives would themselves generally not be subject to regulation under the Act, but the Act will impact their ability to trade these products.

- Generally, users entering into commercial hedging transactions would be excluded from having to register as major swap participants.
- Non-financial end-users would have the option not to have their trades submitted for clearing.
- There appears to be no explicit exemption from requirements to post margin in connection with uncleared transactions, although some legislators have stated that the Act was not intended to impose such requirements on end-users. Margin requirements are supposed to permit the posting of noncash margin.
- Constraints imposed on financial institutions in their own hedging and trading activities, including clearing and exchange trading requirements, may also limit their ability to offer transactions to end-users.

Status

The House approved the final version of the bill 237 to 192 on Wednesday, June 30. A Senate vote on the bill is not expected until mid-July, after Congress returns from a week-long recess for the Fourth of July holiday.

The following is a more detailed summary of key provisions of the Act as they relate to derivatives.

Prohibition on Proprietary Trading

The Volcker Rule

The Act includes what has become known as the "Volcker Rule", which prohibits a "banking entity"[1] from engaging in proprietary trading, among other restrictions.

For these purposes, "proprietary trading" is defined as engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board of Governors of the Federal Reserve System (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 determine. The term 'trading account' means any account used for acquiring or taking positions in such derivatives, 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 as the appropriate Federal banking agencies, the SEC, and the CFTC may determine.

Any nonbank financial company supervised by the Board that engages in proprietary trading will be subject to additional capital requirements for and additional quantitative limits on such proprietary trading. Certain "permitted activities," as discussed below, will not, however, be subject to the additional capital and additional quantitative limits, unless the

[1] This is defined as any insured bank or thrift, company that controls an insured bank or thrift, a company that is treated as a bank holding company under Section 8 of the International Banking Act of 1978, and any affiliate of such an entity.

appropriate Federal bank agencies, the SEC or the CFTC determine that such additional requirements or limitations are appropriate to protect the safety and soundness of the banking entities engaged in such activities.

Not later than six months after the date of enactment of the Act, the Financial Stability Oversight Council (the "**Council**")[2] is required to study and make recommendations on implementing these provisions. Following that, not later than nine months after the completion of the Council's study, the appropriate Federal banking agencies, the SEC, and the CFTC, are to consider the findings of the study and adopt rules to further the purpose of this particular aspect of the Act.

Permitted Activities

The prohibition against proprietary trading of derivatives is not absolute. Certain activities are deemed to be permissible, which include, for example:

- Purchases, sales, acquisitions or dispositions of derivatives on *behalf of customers*
- Trading derivatives *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"
- *Risk-mitigating or hedging activities* in connection with, and related to, individual or aggregated positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such positions, contracts, or other holdings.
- Proprietary trading conducted by a banking entity solely outside of the United States pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, unless the banking entity is directly or indirectly controlled by a banking entity organized in the United States.

Regulators also maintain the ability to in the future add other activities to the list of "permitted activities" if it would "promote and protect the safety and soundness" of the banking entity and U.S. financial stability.

[2] The Act establishes the Financial Stability Oversight Council, the purposes and duties of which are: (a) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or on going activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (b) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and (c) to respond to emerging threats to the stability of the United States financial system. The Council is to achieve these ends through, among other things, the collection of information from various state and federal agencies, monitoring of the financial services marketplace, monitoring of domestic and international regulatory proposals and other developments, and information sharing and coordination among other federal and state agencies. The Council will also report annually to Congress on its activities and significant developments as well as potential emerging threats to the financial stability of the United States.

Limitation on Permitted Activities

Permitted Activities will not include transactions that (i) would involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties, (ii) would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies, (iii) would pose a threat to the safety and soundness of such banking entity, or (iv) would pose a threat to the financial stability of the United States. These limitations are expected to be further defined by regulation. How they are eventually implemented (and interpreted) will be critical to determining the scope of activities that a banking entity is permitted to engage in.

Effectiveness

The provisions of the Volcker Rule are to take effect on the earlier of (a) 12 months after the date of the issuance of the final rules or (b) two years after the date of enactment of the Act. A banking entity or nonbank financial company supervised by the Board will be required to bring its activities and investments into compliance with the requirements of the Volcker Rule not later than two years after the date on which the requirements become effective or two years after the date on which the entity or company becomes a nonbank financial company supervised by the Board. The Board may, however, extend this two-year period by up to three additional one-year periods.

Prohibition against Federal Government Bailouts (the "Push-out")

The Act as approved by the conference committee contains a modified version of the "push-out" provision originally proposed by Senator Lincoln. The Act requires that no Federal assistance be provided to any swaps entity with respect to any swap, security-based swap, or other activity of the swaps entity. The Act defines "Federal assistance" as the use of any advances from a Federal Reserve credit facility or discount window 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, loss sharing, or profit sharing with any swap entity. A swap entity is defined as any swap dealer, security-based swap dealer, major swap participant or major security-based swap participant registered under the Commodity Exchange Act or Securities Exchange Act of 1934. (The definition of "swap entity" excludes insured depository institutions that are major swap participants, but not swap dealers.) In practice, this provision would require banks that currently deal in swaps to transfer their swap businesses to another entity to avoid losing access to Federal assistance, but banks that are non-dealers would be able to retain their swap activities.

The prohibition on Federal assistance does not prevent an insured depository institution from having or establishing an affiliate that is a swaps entity, as long as such insured depository institution is part of a bank 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 and such other requirements as the CFTC or the SEC, as appropriate, and the Board, may determine.

Insured depository institutions that would otherwise be swap dealers will also be able to retain certain limited derivatives activities without losing the benefits of federal assistance. Specifically, the institution may (1) engage in hedging and other similar risk mitigating activities directly related to the insured depository institution's activities; and (2) act as a swaps entity for swaps or security-based swaps involving rates or reference assets that are permissible for investment by a national bank. These reference assets would include interest rates, foreign exchange, gold and silver, government securities and investment grade corporate debt securities, but would generally exclude non-investment grade debt, commodities and equity securities. In addition, credit default swaps may only be entered into under (2) above if cleared.

The bank would have up to 24 months to divest the swaps entity or cease the activities that require registration as a swaps entity. This transition period may also be extended by up to one additional year upon approval by the appropriate Federal banking agency in consultation with the CFTC and the SEC, and conditions to operation may be imposed during the transition period.

In addition, the Council may determine that, if the other provisions established by the Act are insufficient to effectively mitigate systemic risk and protect taxpayers, swaps entities may no longer access Federal assistance. The standards under which the Council could be expected to take such action are unclear.

Regulation of Derivatives Markets

The Act contains provisions for the regulation of the derivatives markets and market participants that are broadly similar to those of the House and Senate bills.

Split jurisdiction between the CFTC and SEC

The Act divides jurisdiction over the derivatives markets between the CFTC and SEC. The CFTC will have jurisdiction over "swaps" and certain participants in the swap market. The SEC will have similar jurisdiction except with respect to "security-based swaps."

Definition of "Swap"

A new definition of "swap" is added to the Commodity Exchange Act that includes a broad range of derivative transactions, including interest rate, currency, equity, credit, fixed income and commodity derivatives, with certain exceptions for physically-settled commodity forwards (including options thereon) and certain securities transactions (such as security options). Over the-counter foreign exchange swaps and forwards are included in the definition of "swap" under the Act. The Secretary of the Treasury, however, has the authority to exempt foreign exchange swap and forwards from the definition of the term swap.[3]

Definition of "Security-based Swap"

The term "security-based swap" is defined as a swap on a single security (or loan) or index comprised of a narrow group of securities. Security-based swaps are excluded from the definition of "swap" and accordingly are subject to the jurisdiction of

[3] In determining whether to exempt foreign exchange swaps and foreign exchange forwards from the definition of the term 'swap', the Secretary of the Treasury must consider: (1) whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards would create systemic risk, lower transparency, or threaten the financial stability of the United States; (2) whether foreign exchange swaps and foreign exchange forwards are already subject to a regulatory scheme that is materially comparable to that established by this Act for other classes of swaps; (3) the extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements; (4) the extent of adequate payment and settlement systems; and (5) the use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements.

the SEC rather than the CFTC. Swaps on a broad-based index of securities, however, will be subject to CFTC jurisdiction. There is also a category of "mixed swaps," involving securities and other reference assets, that will be subject to regulation by both agencies. For convenience, swaps and security-based swaps will be referred to herein as simply "swaps."

Regulation of Market Participants

As proposed in both the House and Senate versions of the legislation, the Act creates new categories of regulated entity: swap dealers and major swap participants.

Swap Dealer

The term "swap dealer" means "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 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." However, an insured depository institution is not considered to be a swap dealer solely due to the fact that it offers to enter into a swap with a customer in connection with originating a loan with that customer. The term also excludes persons who enter into swaps for their own account, either individually or in a fiduciary capacity, but not as part of a regular business. This distinction, while not defined, is similar to one in the definition of dealer under the securities laws, where it is generally understood to distinguish between "trading" activity and "dealing" activity. In addition, the Act provides that the relevant agencies must adopt an exemption for a de minimis amount of swap dealing in connection with transactions with or on behalf of customers. In general, the contours of the swap dealer definition are subject to further clarification by regulation.

The Act contains a parallel category, "security-based swap dealers" with respect to dealings in security-based swaps. For convenience, both swap dealers and security-based swap dealers will be referred to herein as "swap dealers."

Major Swap Participant

The definition of major swap participant, which is intended to cover significant non-dealer market participants, has been controversial throughout the legislative process. As defined in the Act, major swap participants will include:

- any non-swap dealer that maintains a substantial position in swaps for any major swap category, excluding positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan for the primary purpose of hedging risk directly associated with the operation of the plan.
- any non-swap dealer 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."
- any non-swap dealer that (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.

Notably, the second and third categories do not provide any exemption for hedging activity.

The Act includes a parallel registration category for security-based swaps called "major security-based swap participants". For convenience, both major swap participants and major security-based swap participants will be referred to herein as "major swap participants."

The Act leaves key aspects of this definition to be elaborated upon by CFTC and/or SEC regulation, such as the definition of "substantial position" and the major swap categories. The Act stipulates that CFTC and SEC will determine the "substantial position" threshold based on what is "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." Further, the regulators are required to consider the person's relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.

The definition of major swap participant excludes certain financing subsidiaries of corporate manufacturers and similar entities. Specifically, it excludes 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.

Registration

The Act makes it unlawful for any person to act as a swap dealer or major swap participant without being registered with the CFTC and/or SEC, as applicable. The exact nature of the application for registration will be determined by the appropriate regulator, but it will depend on the business in which the applicant is or will be engaged. In addition, the CFTC and SEC will have the authority to prescribe additional rules applicable to swap dealers and major swap participants. Although many swap dealers are likely to be already regulated in some capacity, the requirement to register may mark a significant change for many major swap participants.

A swap dealer or major swap participant is required to register with the CFTC regardless of whether it is also a depository institution or is already registered with the SEC as a security-based swap dealer or major security-based swap participant, and vice versa.

Capital and Margin

The CFTC or SEC, as applicable, will set minimum capital requirements and minimum initial and variation margin requirements for non-bank swap dealers and major swap participants. The applicable bank regulators will set such requirements for swap dealers and major swap participants that are banks. In so doing, the relevant regulator may take into account the risk associated with non-cleared swaps in order to ensure the safety and soundness of the swap dealer or major swap participant.

Unlike some of the prior versions of the legislation, the Act does not provide an explicit exemption from the margin requirement for end-users. Regulators are, however, directed to permit the use of noncash collateral in appropriate circumstances. Nonetheless, depending on how the margin requirement is implemented, this requirement may substantially increase the cost of derivative transactions for end users that are not currently required to post collateral to the dealer counterparties. Market participants have expressed concerns over this provision and are expected to seek exemptions from or changes in this requirement. Senators Dodd and Lincoln have written a letter indicating their view that the legislation was not intended to impose margin requirements on end-users.[4]

Business Conduct

The Act instructs the CFTC and SEC to adopt business conduct requirements that establish a duty for a swap dealer or major swap participant to verify that any counterparty meets the eligibility standards for an eligible contract participant, and impose certain disclosure requirements on the swap dealer or major swap participant. This includes disclosure to a counterparty to the transaction (other than a swap dealer or major swap participant) of information about the material risks and characteristics of the swap, including any material incentives or conflicts of interest that the swap dealer or major swap participant may have. The CFTC will have the authority to establish any other standard or requirements that it deems appropriate for the protection of investors or otherwise furthers the purposes of the Act.

Additional Requirements with "Special Entities"

The Act imposes additional requirements upon swap dealers and major swap participants advising a "special entity" in connection with a swap transaction.[5] Such a swap dealer or major swap participant cannot (i) employ any device or scheme to defraud a special entity, (ii) engage in any transaction or course of business that "operates as a fraud or deceit" on any special entity, or (iii) engage in any act or course of business that is "fraudulent, deceptive or manipulative." Any swap dealer that acts as an advisor to a special entity shall also have a duty to act in the best interests of the special entity and, furthermore, to make a reasonable effort to obtain such information as is necessary to "make a reasonable determination that any swap recommended by the swap dealer is in the best interests of the special entity."

A swap dealer or major swap participant acting as a counterparty (as opposed to an advisor) to a special entity in connection with a swap transaction is required to have a reasonable basis to believe that the special entity has an independent representative that (i) has sufficient knowledge to evaluate the transaction risks, (ii) is not subject to a statutory disqualification, (iii) is independent of the swap dealer or major swap participant, (iv) undertakes a duty to act in the best interests of the counterparty, (v) makes appropriate disclosures, (vi) will provide written representations to the special entity regarding fair pricing and the appropriateness of the transaction, and (vii) in the case of employee benefit plans, is a fiduciary. In such a scenario, the swap dealer must also disclose to the special entity, in writing, the capacity in which it is acting. However, these requirements will not apply to transactions initiated by the special entity on an exchange or swap execution facility and one in which the swap dealer or major swap participant does not know the identity of the counterparty to the transaction. These requirements are less onerous than the fiduciary duty standard that had been imposed in the Senate bill.

[4] Letter from Chairman Christopher Dodd and Chairman Blanche Lincoln to Chairman Barney Frank and Chairman Colin Peterson (June 30, 2010).

[5] Special entity is defined as (i) a Federal agency, (ii) a State, State agency, city, county, municipality, or other political subdivision of a State, (iii) an employee benefit plan, (iv) any governmental plan, or (v) any endowment.

Other Duties

Each registered swap dealer and major swap participant will need to:

- monitor its trading in swaps to prevent violations of applicable position limits;
- establish robust and professional risk management systems adequate for managing the day-to-day business of the swap dealer or major swap participant; and
- disclose to the SEC and/or CFTC, and to the prudential regulator for the swap dealer or major swap participant, as applicable, information concerning (a) terms and conditions of its swaps, (b) swap trading operations, mechanisms, and practices, (c) financial integrity protections relating to swaps, and (d) other relevant information.

Trading and Clearing

Clearing Requirements

The Act requires central clearing for derivatives that are able to be cleared and provides a role for both regulators and clearing houses to determine which contracts must be cleared. The CFTC, in the case of a swap, or the SEC, in the case of a security-based swap, will determine whether a derivative or category of derivatives is subject to the clearing requirements, either at the request of a clearing organization or on its own motion. If a swap is required to be cleared, a party to that swap must submit it for clearing, unless an exemption is available.

Trading Requirement

Transactions that are subject to the clearing requirement must also be executed on a designated contract market or securities exchange or executed on a registered swap execution facility or security-based swap execution facility, as the case may be.[6] The trading requirement does not apply if the transaction is exempt from the clearing requirement or if no exchange or swap execution facility makes the swap available for trading.

Exceptions

The mandatory clearing requirement does not apply to a swap if one of the counterparties (i) is not a financial entity, (ii) is using swaps to hedge or mitigate commercial risk, and (iii) notifies the CFTC or SEC, as applicable, how it generally meets it financial obligations associated with entering into non-cleared swaps. A “financial entity” is defined in the Act as (i) a swap

[6] The term ‘swap execution facility’ means a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that facilitates the execution of swaps between persons and is not a designated contract market. The “multiple participant” references in this definition may exclude the use of single dealer or voice brokerage type arrangements, which may limit the forms of transaction execution that may be available for cleared transactions after the Act comes into effect. The parallel term “security-based swap execution facility” is defined similarly.

dealer, (ii) a major swap participant, (iii) a commodity pool, (iv) a private fund as defined in the Investment Advisers Act of 1940, (v) an employee benefit plan as defined under ERISA, or (vi) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature.

The financial entity definition excludes 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.

The effect of this provision is to limit the clearing/trading exemption to corporate end users engaged in hedging transactions. Hedge funds and similar entities, whether or not they are major swap participants, will likely constitute private funds or commodity pools[7] and thus be ineligible for the exemption.

Clearing Transition Rules

Swaps entered into before the date of the enactment of the Act are exempt from the clearing requirements if reported to a swap data repository (as defined and discussed below). The same applies to swaps entered into before the actual application of the clearing requirement.

Requirements for Clearing Organizations

The Act imposes new and/or additional standards on clearing organizations for derivatives, which must register with the CFTC in order to clear swaps and with the SEC in order to clear security-based swaps. Requirements address, among other matters, margin and risk management, default procedures and governance. Each derivatives clearing organization will be required to maintain records of all activities related to its clearing business. Certain information (including prices and volumes) will be reported to the CFTC or SEC, and will also be available to the public.

The Act did not include specific limits on ownership of clearing organizations by dealers, as had been proposed. However, in order to mitigate conflicts of interest, within 180 days after the date of enactment of the Act, the CFTC or SEC, as appropriate, is required to adopt rules which may include numerical limits on the control of, or the voting rights with respect to, any 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, by a bank holding company with total consolidated assets of $50,000,000,000 or more, a nonbank financial company supervised by the Board, an affiliate of such a bank holding company or nonbank financial company, a swap dealer, major swap participant, or associated person of a swap dealer or major swap participant.

7 It bears noting that the definition of commodity pool has also been revised to include collective investment vehicles that trade in swaps, as well as futures. As a result, such entities will need to have a registered commodity pool operator or an operator that complies with an exemption from CPO registration. Similar changes have been made in the definition of commodity trading advisor.

Clearing organizations deemed to be systemically important may be subject to additional supervision by the Board and Council under Title VIII of the Act.

Clearing Member Requirements and Segregation of Collateral Requirements for Cleared Transactions

The Act requires that cleared swaps of non-clearing members (i.e., customers) be cleared through a registered futures commission merchant. (This may require push-out of customer clearing business currently conducted by banks into an FCM.) With respect to cleared security-based swaps on behalf of customers, however, the clearing member is permitted to be a broker-dealer or a security-based swap dealer. In either case, the act imposes a customer margin segregation regime broadly similar to the FCM segregation model under Section 4d of the Commodity Exchange Act, although the details are left to implementing regulations to be adopted by the CFTC and SEC.

Segregation Requirements for Non-Cleared Transactions

Swap dealers and major swap participants must, upon request of a counterparty, segregate the funds or other property transferred as collateral in connection with a non-cleared trade, and maintain those funds in a separate account with an independent third-party custodian for the benefit of the counterparty. However, this requirement only applies to initial margin, not variation margin. If a counterparty does not ask for its collateral to be segregated, then the Act requires that the swap dealer or major swap participant send quarterly reports to the counterparty indicating that the back office procedures of the swap dealer or major swap participant are in compliance with the agreement between the parties with respect to the handling of collateral.

Reporting to Swap Repositories

The Act requires data collection and publication through clearing houses or swap repositories to improve market transparency and provide regulators tools for monitoring derivative trading activity. Swaps that are not accepted for clearing by a clearing organization must be reported to a registered "swap data repository" or, if one does not exist, to the CFTC or SEC, as applicable. Swaps entered into before the date of enactment of the Act, and that have not already expired by that time, must be reported to a registered swap data repository or the CFTC within 30 days after the issuance of the final rule, or within a timeframe that the CFTC determines to be appropriate. The CFTC is required to determine the final timeframe within 90 days of the date of the Act's enactment.

The term 'swap data repository' means any person that collects and maintains information or records with respect to transactions or positions in, or the terms and conditions of, swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility for swaps.

Position Limits

Under the Act, the CFTC has enhanced position limit and large swap trader reporting authority. The CFTC may also establish limits (including related hedge exemption provisions) on the aggregate number or amount of positions in (i) a particular commodity held by any person or group for each month, (ii) contracts traded by U.S. participants on foreign boards of trade, and (iii) swaps that perform or affect a significant price discovery function. In making a determination that a swap performs or affects a significant price discovery function, the CFTC is to consider the existence of price linkage, arbitrage potential, material price reference and material liquidity.

Additional Provisions

Extraterritorial Reach

It is explicitly stated that the Act's provisions relating to swaps will not apply to activities outside the U.S., unless those activities "(1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent evasion of any provision of this Act... ." The Act contains a parallel provision applicable to security-based swaps, which states that no provision of the derivatives title of the Act, or any rule or regulation, will apply to any person transacting in business in security-based swaps outside the jurisdiction of the United States, unless they transact such business in contravention of the rules and regulations that the Commission prescribes as necessary or appropriate to prevent the evasion of any provision of the derivatives title of the Act.

Although the scope of these two provisions is not entirely clear, it is likely that the requirements of the Act will apply to foreign persons dealing with U.S. counterparties. Whether regulators will permit any exemption for foreign dealers and other persons interacting with U.S. persons (along the lines of CFTC Rule 30.10 for futures or SEC Rule 15a-6 for securities) remains to be seen.

The Act also allows the SEC or the CFTC, in consultation with the Secretary of the Treasury, to prohibit an entity domiciled in a foreign country from participating in the U.S. in any swap and security-based swap if regulation of swaps or security-based swap in such foreign country undermines the stability of the U.S. financial system.

Swaps as Insurance

The Act resolves any uncertainty surrounding the possibility of a state insurance regulator recharacterizing a swap (such as a credit default swap) as an insurance contract. The Act states that a swap or security-based swap shall not be considered to be insurance and may not be regulated as an insurance contract under the law of any State.

International Harmonization

In order to promote effective and consistent global regulation of swaps and security-based swaps, the CFTC, the SEC, and the prudential regulators, as appropriate, are to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation (including fees) of swaps, security-based swaps, swap entities, and security-based swap entities and may agree to such information-sharing arrangements as may be deemed to be necessary or appropriate in the public interest or for the protection of investors, swap counterparties, and security-based swap counterparties.

Anti-disruptive Practices

Regulators are given broad authority to make and promulgate rules and regulations that they consider necessary to prohibit the type of trading described in the Act as "disruptive," such as spoofing, or any other practice that is disruptive of fair and equitable trading. Furthermore, the Act makes it unlawful for any person to enter into a swap knowing, or acting in reckless disregard of the fact, that its counterparty will use the swap as part of a device, scheme, or artifice to defraud any third party. These new requirements could impose substantial additional liabilities on swap market participants.

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Effectiveness

The derivatives regulation provisions of the Act generally take effect 360 days after enactment or, if a provision requires rulemaking, 60 days after publication of the final rule. Market participants have raised concerns about whether certain provisions, particularly the margin requirements would apply to swaps in existence at the time the Act takes effect. Certain provisions, such as the clearing requirement, expressly would not apply to existing swaps provided that they are reported to a repository as provided in the Act.

Conclusion

The Act establishes a fundamentally new framework for derivatives regulation in the United States. Its full implications will not be known until the many rules and regulations contemplated by the Act have been adopted over the course of the next year (and beyond). We will continue to monitor these developments as and when implementation of the Act begins.

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