# The Wall Street Reform Act and the Derivatives Market

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"). A response to the financial crisis of 2008 and circumstances that came to light thereafter, the Act imposes new restrictions and regulatory oversight on a broad array of financial activities and companies.

This eAlert focuses on the effect of the Act on the derivatives market.

## New Oversight

The new statute charges the Securities and Exchange Commission (the "SEC") with oversight of security-based swaps, security-based swap dealers, and major security-based swap participants, while the Commodity Futures Trading Commission (the "CFTC" and, together with the SEC, the "Commissions") will have oversight of other swaps, swap dealers, and major swap participants.* The Act requires the SEC and the CFTC to develop new regulations applicable to all swaps in the coming year and to work together in their regulatory capacities going forward.

Although the Act provides a definition of the relevant terms, the two Commissions may add additional transactions to the final definitions of the terms "swaps," "security-based swaps," and related terms. "Swaps" are defined to include, among other transactions: interest rate swaps; rate floors, caps, and collars; basis swaps; foreign exchange swaps (subject to a potential exemption described below); commodity swaps; credit spreads; and credit default swaps. "Security-based swaps" are defined as swaps (as defined above) that are based on (1) a narrow-based security index, (2) a single security or loan, or (3) the occurrence of an event relating to a single issuer of a security or issuers of securities in a narrow-based index, provided such event has a direct impact on the issuer's financial statements, obligations, or condition.

The Act requires the two Commissions to conduct various studies, including a study on whether electronically designed and accessible algorithmic definitions of swaps should be employed in describing complex financial derivatives as part of the binding legal definition thereof, in analyzing such transactions, and in calculating the net exposures related thereto. Of note, by use of the words "complex *and standardized* financial derivatives" (emphasis added), the Act seems to acknowledge that such algorithmic representations will only work for complex transactions that are common and uniform. Furthermore, the two Commissions may, by order or rule, investigate, collect information, and issue reports on swaps determined to be detrimental to the stability of, or participants in, a financial market.

Among other matters, the Commissions will be developing regulations on the maintenance of books and records regarding swaps, including daily trading records for dealers and major participants. Dealers and major participants are likely to be subject to higher capital and margin requirements, as well as more stringent daily record-keeping obligations and new position limits, once regulations are implemented.

## New Requirements regarding Clearing

After the effective date of the Act and implementation of regulations, certain swaps and security-based swaps identified by the Commissions will be required to be submitted to a derivatives clearing organization or clearing agency registered with the CFTC or SEC, respectively, or exempt from such registration. The terms "swap" and "security-based swap" are subject to further definition by the

Commissions, and the Commissions will be determining which "swaps" and "security-based swaps" will be required to be cleared.

The clearing requirement, which is aimed at reducing credit risk of derivatives counterparties, will almost certainly result in higher capitalization of clearing organizations and agencies. In fact, the Act, itself, provides that a clearing organization must have sufficient financial resources to cover its operating costs for a period of one year and to meet its obligations in the face of a default by the participant creating the organization's largest exposure in extreme but plausible market conditions. The potential issue with the clearing requirement is that all the risk will be concentrated in those clearinghouses, posing a significant threat of a market meltdown if they are not sufficiently capitalized.

There is a narrow exception to the clearing requirements, where one counterparty to the swap is not a "financial entity," is engaged in the swap to hedge commercial risk, and notifies the applicable Commission of how it meets its obligations in uncleared swaps. Interestingly, this exception from the clearing requirement only applies at such counterparty's option.

With respect to major participants and dealers involved in swaps that are not required to be submitted to a clearing organization or agency, the Commissions (and the relevant prudential regulator, if applicable) will be establishing capital requirements and both initial and variation margin requirements. Furthermore, if no clearinghouse has listed a particular type of swap that either Commission determines would otherwise have been subject to the clearing requirement, the Act authorizes them to take all necessary action that is in the public interest, including imposing margin requirements.

Covered swaps entered into before the effective date of the Act are exempt from the clearing requirements, but only if they are timely and properly reported to a swap data repository that will keep centralized records for swaps (or if none is accepting such swaps, then to the applicable Commission). This requirement applies to covered swaps that were entered into before enactment of the Act on July 21, 2010, whose terms had not expired as of July 21, 2010.

All swaps required to be submitted to a clearing organization or agency will also be required to be traded on an exchange or a board of trade designated as a contract market or a swap execution facility registered with the applicable Commission or exempt from such registration. The only exceptions appear to be if no such exchange, board of trade, or facility makes such swap available for trade or if such swap is subject to the exception from clearing, referenced above, for a company that is not a "financial entity."

### Foreign Exchange Swaps and Forwards

The Act currently covers foreign exchange ("F/X") swaps and forwards but leaves the door open to the possibility of exempting such transactions from regulation generally, leaving the final determination to the Secretary of the Treasury (the "Secretary"). In order to exempt them, the Secretary must determine that F/X swaps and forwards are not structured to evade the Act and that they should be exempt, and s/he will have to prepare a report to the applicable committees of Congress explaining why they are qualitatively and substantively different than other swaps, making them ill-suited for regulation under the Act.

Notwithstanding such a determination by the Secretary, exempted F/X swaps and forwards will remain subject to at least two requirements. First, they must be reported to either a swap data repository or, if none is accepting such swaps, to the CFTC. In addition, swap dealers and major swap participants will be subject to certain business conduct standards. The business conduct standards will require dealers and major participants to: (1) determine each counterparty's eligibility to participate in trades; (2) disclose to the counterparty (a) the transaction's material risks, (b) the dealer's or major participant's material incentives and any conflict of interest, and (c) the daily marking of the transaction; (3) comply with duties related to fair dealing and good faith; and (4) comply with other standards to be developed by the CFTC to prevent abusive practices, incentivize diligent supervision of the business and adherence to position limits, and otherwise advance the purposes of the Act.

## International Derivatives Market

The Act expands the regulatory agencies' authority over international derivatives activity. The Commissions, in consultation with the Secretary, can now prevent foreign entities from participating in US swap activities if the foreign entity's jurisdiction has swap regulations that "undermine the stability of the US financial system." There is some question whether the jurisdiction in which the foreign entity is domiciled is the relevant jurisdiction. Moreover, this type of regulatory authority may lead to a chilling effect on US trading, at least until the US regulations are fully developed and it becomes clear what type of regulatory system poses the risk of "undermining" the financial stability of the US system. However, this provision of the statute was likely intended to incentivize standardization of derivatives market regulation worldwide. In fact, the Act requires the Commissions to consult and coordinate with foreign regulatory authorities to establish consistent international standards with respect to the swap market. Fully aware of the global nature of the derivatives market, Congress charged the two Commissions with studying the effect of the Act on US trading vis-à-vis international trading, among other studies, over the course of the next 8 to 18 months.

## Conclusion

In short, the impact of the Act on the derivatives market remains to be seen. The results of the studies being conducted by the Commissions and the regulations that they decide to implement will provide greater visibility into the effects that this sweeping legislation will ultimately have on financial markets.

*For purposes hereof, we will refer to swaps, dealers, and major participants generally, unless the context requires a distinction between swaps, swap dealers and major swap participants in contrast to security-based swaps, security-based swap dealers, and major security-based swap participants.

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