

Investment Funds Alert

Congress Regulates Over-the-Counter Derivatives

July 30, 2010

The Wall Street Transparency and Accountability Act of 2010 (the “Derivatives Act”), enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010, applies much of the regulatory framework of the commodity futures market to swaps contracts between “eligible contract participants” (ECPs) and imposes a new registration requirement for certain large swap market participants. Specifically, the Derivatives Act (1) requires most swaps to be cleared (even for ECPs), (2) imposes regulatory requirements for persons that have large positions or make markets in swaps, (3) requires margin for almost all swaps transactions and (4) imposes position limits on swaps. The Derivatives Act requires that the Commodity Futures Trading Commission (CFTC) adopt rules to enact the Derivatives Act as it relates to most types of swaps. The term “swap” is broadly defined and includes currency swaps and forwards unless excluded by the secretary of the Treasury.¹

The Derivatives Act also includes separate provisions for swaps that are based on a security, narrow-based security index, a loan or the occurrence or nonoccurrence of an event relating to an issuer or the issuers of the securities comprising the narrow-based index (a “Security-Based Swap”) and authorizes the Securities and Exchange Commission (SEC) to oversee Security-Based Swaps. The CFTC has jurisdiction over all swaps other than Security-Based Swaps. The SEC and the CFTC will coordinate regulations relating to each type of swap.

The Derivatives Act also prevents federal assistance to many swap industry participants, and it provides the SEC with the express authority to require securities holders to include the securities underlying Security-Based Swaps in the reporting requirements for 5 percent beneficial owners, directors and executive officers of public companies.

Unless specifically provided otherwise below, the Derivatives Act will be effective on the later of (1) 360 days after the date of enactment of the Derivatives Act or (2) 60 days after the rulemaking for provisions implemented through a rule making.

Clearing Requirement

CFTC–Regulated Swaps

Unless exempt from the jurisdiction of the CFTC under the Commodity Exchange Act (CEA), contracts that are of the character of a commodity futures contract or an option thereon are required to be traded through designated contract markets (DCMs). The Derivatives Act removes many exemptions from CFTC jurisdiction,² such as the exemption for individually negotiated swaps, and forces trading onto exchanges and/or cleared trading through derivatives clearing organizations (DCOs). The CEA, as revised by the Derivatives Act (the “Amended CEA”) prohibits any person other than an ECP from entering into a swap unless it is entered into on, or subject to, the rules of a board of trade designated as a contract market.

¹ For full definition of “swaps” from the Derivatives Act, please click [here](#).

² The exclusions deleted from the CEA include Sections 2(d) (transactions in excluded commodities outside of a trading facility between ECPs and transactions on electronic exchanges between certain ECPs on a principal-to-principal basis), 2(e) (transactions over electronic trading facilities), 2(f) (hybrid instruments that are mostly securities), 2(g) (exemption for individually negotiated swap contracts between ECPs not traded on an exchange) and 2(h) (transactions in exempt commodities not entered into through a trading facility and principal-to-principal transactions between eligible commercial entities executed on an electronic trading facility).



Regardless of whether either (or both) of the parties to a swap is an ECP, the Amended CEA prohibits any person, subject to exceptions, from entering into a swap unless that person submits a swap for clearing by a DCO.

The DCO may then either (1) accept the swap and submit it through a CFTC approval process within 90 days or (2) reject the swap, in which case it must still be reported to a registered swap data repository (RSDR). In determining whether a swap should be cleared, the CFTC will take the following factors into account: (1) the existence of significant outstanding notional exposures, trading liquidity and adequate pricing data; (2) the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded; (3) the effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the derivatives clearing organization available to clear the contract; (4) the effect on competition, including appropriate fees and charges applied to clearing; and (5) the existence of reasonable legal certainty in the event of the insolvency of the DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds and property. The CFTC is required to adopt rules for the DCO submission process within one year of enactment.

The new mandatory clearing requirement does not apply to a person that (1) is not a financial entity, (2) is using swaps to hedge or mitigate risk and (3) files a notice with the CFTC, in a manner set forth by rule, indicating how the person meets financial obligations relating to the non-cleared swap. A person who is eligible to use the exemption may choose to clear the applicable swap and the DCO that will be used. A “financial entity” is defined as (1) a swap dealer, (2) a security-based swap dealer, (3) a major swap participant (MSP), (4) a major security-based swap participant (MSBSP), (5) a commodity pool, (6) a private fund (i.e., an issuer that would be an investment company if it were not for the operation of Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940), (7) an employee benefit plan or (8) a person predominantly in the banking business (subject to an exemption for small institutions) or involved in activities that are financial in nature. Affiliates of such exempt persons may also be able to use the exemptions. Also, if a person is able to use the above exemption, but is also an issuer of securities that are registered under Section 12 of the Securities Exchange Act of 1934 (the “Exchange Act”), the exemption is only available if an appropriate committee of the board of directors of that issuer has reviewed and approved entering into swaps that are subject to a clearing exemption.

Swaps entered into prior to the enactment of the Derivatives Act are exempt from the application of the clearing provisions if the swaps are reported to an RSDR or the CFTC. (The reporting deadlines for those swaps is set forth under “Requirements for Registered Swap Data Repositories and Registered Security-based Swap Data Repositories” below.)

If a swap is not subject to clearing, swap dealers and MSPs are required to offer their counterparties the right to require the funds or other assets used to margin or secure the obligations of the counterparty to be segregated and held in an account with a third-party custodian in a manner specified by CFTC rule. The segregation requirement does not apply to variation margin. If the counterparty does not choose segregation, the swap dealer or MSP must report its back office safeguards to the counterparty on a quarterly basis.

Security-Based Swaps

The Exchange Act, as revised by the Derivatives Act (the “Amended Exchange Act”), expands the definition of “security” to include security-based swap.³ Any person filing a proposal to list or trade a novel derivative product that may have elements of both securities and commodity futures contracts (or options on such contracts or options on commodities) may concurrently provide notice to both the SEC and the CFTC. If no concurrent notice has been provided for such novel derivative product, the SEC or the CFTC, as applicable, shall notify the other and provide a copy of the filing.

The Amended Exchange Act prohibits any person other than an ECP from entering into a security-based swap unless such transaction is effected on a registered national securities exchange. Similar to the requirement to trade swaps through DCOs under the Amended CEA, the Amended Exchange Act requires most traders to enter into security-based swaps through clearing agencies (CAs) registered with the SEC. Regardless of whether either (or both) of the parties to a swap is an ECP, the Amended Exchange Act prohibits any person from entering into a security-based swap unless such security-based swap is submitted for clearing by a CA. The CA will then submit those swaps to the SEC for approval either by group, category, type

³ Also, any agreement, contract or transaction (or class thereof) that the CFTC has exempted with the condition that the SEC exercise concurrent jurisdiction with the CFTC over such agreement, contract or transaction (or class thereof) shall be deemed a “security” for the purposes of the securities laws.

or class of security-based swaps within 90 days. The SEC is required to adopt rules for the Security-Based Swap submission process within one year of enactment.

Both parties to security-based swaps that are not accepted by any CA are required to report their swaps to a registered security-based swap data repository (RSBDR), or, if no RSBDR would accept the security-based swaps, the SEC, within 90 days after the execution date or such earlier date determined by the SEC. Security-based swaps entered into prior to the adoption of the Derivatives Act are required to be reported to an RSBDR or the SEC within 30 days of enactment of final rules relating to the Derivatives Act by the SEC.

Clearing, Reporting and Trading Entities

CFTC-Regulated Swaps

The Amended CEA brings a much more exchange-like experience to entering into cleared swaps through the regulatory requirements applicable to DCOs. Each DCO is required to register with the CFTC and must comply with certain core principles that will dramatically change the market for persons who enter into swaps that are cleared through a DCO. First, DCOs are required to have risk management systems that (1) collect margin on at least a daily basis in an amount sufficient to cover potential exposures in normal market conditions, (2) measure credit exposures of the DCO and its participants, (3) limit the amount of potential losses from defaults for the DCO and other participants and (4) regularly update and review risk-based models used in calculating required margin. Second, DCOs are required to adopt procedures to ensure the settlement of trades and the safety of client assets. Third, DCOs must hold member and participant funds in a manner that minimizes the risk of loss, including limits on the types of investment that may be made with such account. Fourth, DCOs are required to adopt rules and procedures relating to the default of participants. In addition, DCOs are also required to (1) publicly disclose, among other things, margin methodology, the terms and conditions of the agreements cleared and settled by the DCO and the daily settlement prices and open interest, (2) enforce the DCO's rules, (3) satisfy minimum capital requirements (including a one-year operating reserve), (4) impose system safeguards, (5) report to the CFTC, (6) maintain records as specified by the CFTC, (7) establish governance and fitness standards, (8) limit conflicts of interest and (9) collect and maintain swaps data to share with the CFTC and other specified regulators. Any money, securities or property used to secure a swap contract through a DCO or CA must be held by a futures commission merchant in a segregated account.

Security-Based Swaps

A CA is required to register with the SEC and comply with the standards established by the SEC, which are very similar to those applicable to DCOs.

Swap Execution Facilities

If a cleared swap has been accepted for trading by a DCM or a "swap execution facility" (as defined below), the Cleared Swap must be executed through a DCM or a registered exempt swap execution facility. "Swap execution facilities" are defined as trading platforms other than DCMs that permit the acceptance of bids and offers.

Swap execution facilities are required to register with the CFTC, subject to certain exceptions for swap execution facilities that are already subject to similar regulations. Once registered, swap execution facilities will also be required to adopt rules or systems in compliance with core principles to (1) limit access to the swap execution facility, (2) prohibit swaps that are subject to manipulation, (3) monitor trade processing, (4) establish position limits, (5) require information to be reported or available to the swap execution facility, (6) ensure financial integrity of transactions, (7) allow for the imposition of emergency limitations on the trading of swaps, (8) maintain records, (9) maintain sufficient financial resources, (10) implement system safeguards and (11) implement compliance procedures through a chief compliance officer.

Requirements for Registered Swap Data Repositories and Registered Security-based Swap Data Repositories

Swaps that are not accepted by a DCO for clearing and swaps that have not expired, but were entered into prior to the enactment of the Derivatives Act shall be reported to an RSDR by the swap dealer, MSP or, if no counterparty is a swap dealer or MSP, an agreed-to counterparty. If no RSDR accepts the swap for reporting, the swap must be reported to the CFTC. Because RSDRs are subject to fewer requirements than DCMs, trading in reported swaps will not resemble trading

on a DCM for commodity futures. RSDRs will be required to (1) register with the CFTC, (2) collect data complying with standards set by the RSDR and (3) maintain data and provide that information on a confidential basis to regulators, including the CFTC and the SEC. RSBSDRs will be subject to similar requirements, except they will be registered with the SEC, which shall retain exclusive jurisdiction to prescribe recordkeeping and reporting requirements for a RSBSDR.

Swaps entered into prior to the adoption of the Derivatives Act are required to be reported to an RSDR or the CFTC within 180 days of the effective date of the Derivatives Act. Swaps entered into after the enactment of the Derivatives Act shall be reported within the later of 90 days after the effective date or such time as the CFTC determines by rule.

Reporting

Swaps that are subject to mandatory clearing through either a DCM or a DCO are subject to real-time reporting. Swaps that are reported to an RSDR are subject to anonymous reporting requirements. The CFTC also may require registered entities to publicly disseminate swap transaction and pricing data.

Security-based swaps that are subject to mandatory clearing or have been cleared through a CA are subject to real-time reporting. Security-based swaps reported to an RSBSDR or the SEC are subject to anonymous reporting requirements. The SEC also may require registered entities to publicly disseminate the security-based swap transaction and pricing data.

Accountability and Position Limits

Entering into swap contracts that perform a price discovery function will be subject to reporting for large traders and position limits. The reporting requirements for those swaps will apply if the large trader enters into a swap in excess of a CFTC-specified intraday threshold or absolute threshold. Large swap traders that report to the CFTC will also be required to maintain records relating to the swap and the related notional commodity.

The Derivatives Act also requires the CFTC to adopt several new speculative position limits relating to commodities and swaps. The first new speculative position limit will be a combined limit for (1) commodity futures contracts entered into through a DCM or swap execution facility, (2) swaps entered into through a DCM or swaps execution facility and (3) swaps not so traded that perform a significant price discovery function (an SPDS)⁴ for a registered entity. The second required position limit is for swaps that are economically equivalent to commodity futures contracts or options thereon. The third required position limit is an aggregate position limit for (1) listed contracts, (2) agreements that settle against the price of the listed contract or a contract on a foreign board of trade providing United States persons with direct access and (3) SPDSs. The final required position limit is a CFTC limit on commodity futures contracts or options thereon (including those relating to exempt commodities) traded on a DCM.

Each of the above speculative position limits are subject to bona fide hedging exceptions. The Derivatives Act, however, limits the use of the bona fide hedging exemption to positions that (1) represent substitutes for positions taken or to be taken at a later time in the physical market, (2) are economically appropriate for risk management in a commercial enterprise and (3) arise from potential change in value of: assets that a person owns, produces, manufactures or merchandizes or anticipates so doing; liabilities that a person has or anticipates incurring; or services that a person provides, purchases or anticipates providing. Hedging relating to swaps is limited to those swaps that are executed opposite a counterparty that would qualify for that bona fide hedging exemption and those that would independently qualify for the modified exemption.

The SEC shall establish position limits (including related hedge exemption provisions) on the size of positions in any security-based swap that may be held by any person. In establishing such limits, unless the SEC exempts any person, security-based swap or transaction (or class thereof), the SEC may require a person that effects transactions for its own account or the account of others to aggregate positions in (1) any security-based swap and any security, loan, or groups of securities or loans on which such security-based swap is based, which it references, or to which it is related, and other related instruments or (2) any security-based swap and (a) any security or group or index of securities, the price, yield, value, or

⁴ In determining whether a swap contract is an SPDS, the CFTC will look to the price linkage of the swap to a contract traded on a regulated market, whether the swap permits a person to use the swap arbitrage between markets, whether the prices of the contract traded on a regulated market are based on, or referenced to, the price of the swap and the extent to which the volume of swaps has a material effect on contracts traded on a regulated market.

volatility of which, or of which any interest therein, is the basis for a material term of such security-based swap and (b) any other instrument relating to the same security or group or index of securities. The SEC may also require large trader reporting with respect to such positions.

Regulation of Swap Market Participants

In addition to the regulation of the swap markets, the Derivatives Act will impose a new level of regulation on swap dealers and MSPs. The Amended CEA defines swap dealers similarly to “dealers” under the Exchange Act to include persons that (1) hold themselves out as dealers in swaps, (2) make a market in swaps, (3) regularly enter into swaps with counterparties as an ordinary course of business for its own account or (4) otherwise engage in any activity causing the persons to be known as a dealer or market maker in swaps. Persons who enter into swaps for their own account or in a fiduciary capacity but not as a part of their regular business and persons who engage in de minimis swap dealing in connection with transactions with, or on behalf of, customers shall not be included in the definition of “dealer.”

“MSPs” are defined as persons other than swap dealers that (1) maintain a substantial position (as defined by the CFTC by rule) in swaps for any of the major swap categories (as determined by the CFTC) excluding positions for hedging or mitigating commercial risk or risk directly associated with plans regulated by the Employee Retirement Income Security Act of 1974 (ERISA), (2) have outstanding swaps that create substantial counterparty exposure that could have “serious adverse effects” on the financial stability of the U.S. banking system or financial system or (3) are highly leveraged financial entities that maintain a substantial position (other than certain positions related to hedging currency and interest rate risks) in swaps.

Swap dealers and MSPs are each required to register with the CFTC and are subject to regulatory and prudential requirements either under rules promulgated by the CFTC or, for depository institutions, under rules promulgated by the appropriate federal regulator. MSPs and swap dealers are subject to the following requirements: (1) capital requirements for non-cleared swaps, (2) initial and variation margin requirements for swaps that are not cleared, including non-cash collateral,⁵ (3) reporting requirements regarding their financial condition and positions, (4) recordkeeping requirements (which are subject to examination), (5) daily trading recordkeeping requirements (including counterparty information and audit trail), (6) back office requirements, (7) trade position monitoring requirements, (8) risk management requirements, (9) disclosure requirements to the CFTC for terms and conditions, mechanics of trading and financial integrity protections, (10) verification of the eligibility standards for swap counterparties, (11) compliance requirements, including the appointment of a chief compliance officer and an annual self-assessment and (12) disclosure requirements to counterparties to swaps of risks, fees, material conflicts of interest and the daily mark. The CFTC may impose the above registration and prudential requirements for one class of swaps and not another.

MSPs and swap dealers are subject to enhanced requirements and duties when dealing with “special entities,” which consist of federal state and local agencies, employee benefit plans or government plans under ERISA and endowments, including charitable endowments. MSPs and swap dealers advising special entities shall be subject to (1) a duty to act in the best interests of the special entity, (2) a duty to take reasonable efforts to obtain information necessary to determine that the swap is in the best interests of the special entity and (3) separate antifraud restrictions. MSPs and swap dealers acting as counterparties to a special entity are required to confirm that the special entity has a special representative that meets certain sophistication and fiduciary requirements, and the MSP or swap dealer must disclose the capacity in which it is acting to the special entity. The above requirements shall not apply to transactions with a special entity on an exchange or a swap execution facility if the MSP or swap dealer does not know the identity of its counterparty.

Regulation of Security-Based Swap Market Participants

In addition to the regulation of the security-based swap markets, the Derivatives Act will impose a new level of regulation on security-based swap dealers and MSBSPs. Security-based swap dealers and MSBSPs are required to register with the SEC and are subject to regulatory and prudential requirements, including those related to “special entities” either under rules promulgated by the SEC or, for depository institutions, under rules promulgated by the appropriate federal regulator that are the same as the requirements to which MSPs and swap dealers are subject.

⁵ The DCO margin requirements will apply to swaps entered into through a DCO.

In addition, MSBSPs and security-based swap dealers are subject to standards of care, including ensuring that the ECP counterparty is knowledgeable and independent. They are also subject to “dual registration,” i.e., any person that is required to be registered as a security-based swap dealer or MSBSP shall register with the SEC, regardless of whether the person also is registered with the CFTC as a swap dealer or MSP, respectively.

Sections 13(d), 13(g) and 16 Beneficial Ownership Reporting Requirements for Security-Based Swaps

Persons who enter into securities-based swaps under the Exchange Act were traditionally not required to include the exposure to the notional (or underlying) security in determining whether a person was a 5 percent owner required to file a Schedule 13D or a 10 percent owner required to file a Form 3 under Section 16 of the Exchange Act. The Derivatives Act expands each of Section 13(d)(1), Section 13(g)(1) and Section 16 of the Amended Exchange Act to include beneficial ownership resulting from entering into a security-based swap that the SEC may define by rule. A person shall be deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap, only to the extent that the SEC, by rule, determines, after consultation with the prudential regulators and the secretary of the Treasury, (1) that the purchase or sale of the security-based swap or class of security-based swap provides incidents of ownership comparable to direct ownership of the equity security, and (2) that it is necessary to achieve the purposes of Section 13 that the purchase or sale of the security-based swaps or class of security-based swap be deemed the acquisition of beneficial ownership of the equity security. As a result, the reporting obligations under Section 13 and Section 16 may be expanded to include certain purchases and sales of security-based swaps, depending on the actual rules established by the SEC.

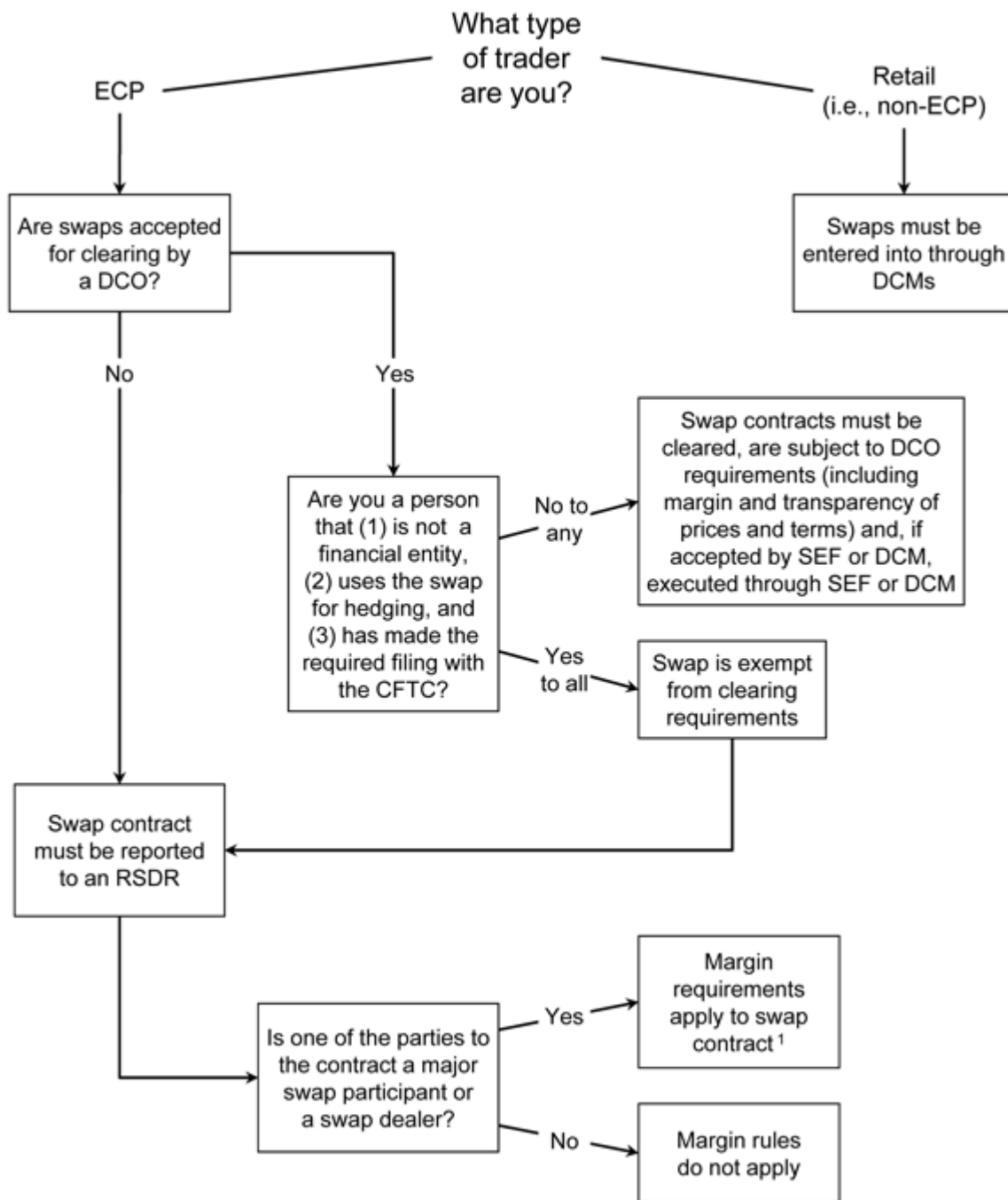
Prohibition of Assistance

The Derivatives Act also prohibits any federal assistance, including loans, asset purchases, guarantees or loss sharing, from being provided to any “swaps entities.” “Swaps entities” are defined to include swap dealers, security-based swaps dealers, MSPs and MSBSPs. The restriction does not apply, however, to insured depository institutions that comply with certain requirements and limitations.

Conclusion

When the Derivatives Act takes effect, it will change the operation of the market for swaps by requiring most swaps to be cleared and executed through DCMs or swap execution facilities, imposing aggregate position limits on swaps and regulating large industry participants. Swaps entered into prior to enactment of the Derivatives Act are exempt from many of the requirements of the Derivatives Act (such as clearing) but will be required to be reported. The final regulations to be adopted by the SEC and the CFTC may, however, significantly broaden the impact of the Derivatives Act, especially with respect to registration as an MSP or MSBSP. We will keep you up to date as those regulations are promulgated.

Trading of Swaps



¹According to statements made by representatives of both parties in the conference committee, margin requirements are not supposed to apply to entities that satisfy the above three factors. Clearer language exempting those entities from margin may be taken up in a technical amendments bill or through the CFTC rule making process.

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