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DERIVATIVES MONTH IN REVIEW

MAY 2012

Dodd-Frank Act Implementation Update

Title VII of the Dodd-Frank Act, titled the "Wall Street Transparency and Accountability Act of 2010" ("Title VII"), was enacted on July 21, 2010.[1] Under the Dodd-Frank Act, which is generally intended to bring the $700 trillion over-the-counter derivatives market under greater regulation, the Commodity Futures Trading Commission ("CFTC") has primary responsibility for the regulation of "swaps" and the Securities and Exchange Commission ("SEC" and, together with the CFTC, the "Commissions") has primary responsibility for the regulation of "security-based swaps." A summary of certain noteworthy developments in the implementation of Title VII since our last update follows.

The Definition of "Swap Dealer"

On April 18th, the CFTC approved the final definition of "swap dealer"[2] under Title VII in a joint rulemaking with the SEC. The final rule, which also defined such terms as "major swap participant" and "eligible contract participant," is viewed favorably by many non-financial energy companies and large commodity traders that strongly opposed the CFTC's initial definition of swap dealer proposed in December 2010.

Title VII subjects swap dealers to substantial regulation (including registration, mandatory exchange trading and clearing requirements, margin and capital rules, robust business conduct standards and reporting and recordkeeping requirements) but provides an exemption from the swap dealer category for entities that engage in only *de minimis* swap dealing activity. In quantifying the statutory *de minimis* exemption, the CFTC initially proposed a $100 million maximum for the aggregate gross notional amount of swaps that an entity enters into over the prior 12 months in connection with its dealing activities.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010). The text of the full Dodd-Frank reform is available at http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.

[2] A "swap dealer" is defined under Title VII, with certain exceptions, as any person that: (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 own 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. To qualify as a swap dealer, a person must enter into swaps for such person's own account, either individually or in a fiduciary capacity, as part of a regular business. A person may be designated as a swap dealer for one or more types or classes of swaps but not others.

This proposal faced harsh criticism from numerous non-bank market participants and industry groups, which voiced concerns about the costs associated with registering as swap dealers and complying with the related requirements.

The final definition of swap dealer raises the *de minimis* cap to $8 billion from $100 million during an initial phase-in period.[3] However, the CFTC is required to prepare a study of the swap markets two-and-a-half years after data begins to be reported to swap data repositories ("SDRs").[4] Nine months after the preparation of that study, the CFTC may decide to end the phase-in period and propose to change the *de minimis* cap either higher or lower. If the CFTC does not take any action to end the phase-in period, it will automatically terminate five years after data begins to be reported to SDRs and the *de minimis* cap will become $3 billion. Notwithstanding these caps, a party that enters into in excess of $25 million in aggregate gross notional amount of swaps with "special entities"[5] over the prior 12 months will qualify as a swap dealer during and after the phase-in period.

A person may apply to the CFTC to limit its designation as a swap dealer to specified categories of swaps or specified activities in connection with swaps. The CFTC expects that approximately 125 entities will fall under the final swap dealer definition.

Clearing Documentation, Trade Acceptance and Risk Management

On April 9th, the CFTC published final rules covering various matters relating to the central clearing of swaps.[6] Specifically, the final rules address: (i) the documentation between a customer and a futures commission merchant ("FCM") clearing trades on behalf of the customer; (ii) the timing of acceptance or rejection by derivatives clearing organizations ("DCOs") and clearing members of trades submitted for clearing ; and (iii) the risk management procedures of FCMs, swap dealers and major swap participants that are clearing members.

With respect to customer clearing documentation, the final rule prohibits FCMs, swap dealers, major swap participants and DCOs from entering into arrangements that would, among other things: (i) disclose to the FCM, swap dealer or major swap participant the identity of a customer's original executing counterparty; (ii) limit the number of counterparties with which a customer may enter into a trade; or (iii) restrict the size of a customer position with any individual counterparty (other than an overall credit limit for all customer positions held at an FCM).

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[3] In determining whether its swap activity causes it to be covered by the "swap dealer" definition, a person will be permitted to exclude certain swaps, including those entered into: (i) between an insured depository institution and customer in connection with the origination of a loan with the customer (subject to certain conditions, including that the swap is connected to the financial terms of the loan or is required by loan underwriting criteria); (ii) between majority-owned affiliates; and (iii) between an agricultural or financial institution cooperative and its members. Also, pursuant to an interim final rule inviting comment, the CFTC proposes that swaps hedging physical positions also be excluded, subject to certain conditions.

[4] In November 2011, both The Depository Trust & Clearing Corporation and IntercontinentalExchange, Inc. filed registration applications with the CFTC to operate SDRs.

[5] A "special entity" is defined to include federal agencies; States, State agencies, cities, counties, municipalities or other political subdivisions of a State; employee benefit plans under ERISA; governmental plans under ERISA; and endowments (including organizations described in section 501(c)(3) of the Internal Revenue Code of 1986, as amended).

[6] Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. 21278 (Apr. 9, 2012).

With respect to the clearing of a swap that is not executed on either a designated contract market ("DCM") or swap execution facility ("SEF"), the final rules provide that such a swap be submitted for clearing to a DCO, generally: (i) as soon as technologically practicable after execution but no later than the close of business on the execution date, where the swap is subject to mandatory clearing; and (ii) by the next business day after the execution date (or after the date of agreeing to clear, if later than the execution date), where the swap is not subject to mandatory clearing, but the parties have elected to clear the trade. The final rules do not mandate automatic trade processing or prescribe a particular method of trade processing. Rather, they establish a performance standard and require the acceptance or rejection of trades submitted for clearing as quickly as would be technologically practicable if fully-automated systems were used. Moreover, the final rules recognize that DCOs will need to screen trades to ensure that they satisfy product and credit criteria before accepting or rejecting them.

With respect to risk management, the final rules require swap dealers, major swap participants and FCMs that are clearing members to: (i) establish risk-based limits based on position size, order size, margin requirements, or similar factors; (ii) screen orders for compliance with the risk-based limits; (iii) monitor for adherence to the risk-based limits intra-day and overnight; (iv) conduct stress tests of all positions at least once per week; (v) evaluate its ability to meet initial margin requirements at least once per week; (vi) evaluate its ability to meet variation margin requirements in cash at least once per week; (vii) evaluate its ability to liquidate positions it clears in an orderly manner, and estimate the cost of the liquidation; and (viii) test all lines of credit at least once per year.

The final rules become effective for DCOs, DCMs and FCMs on October 1, 2012. However, for swap dealers and major swap participants, the final rules become effective on the later of October 1, 2012 and the date on which such entities are required to register as such, and for SEFs, on the later of October 1, 2012 and the date on which the rules implementing core principles for SEFs become effective.