

## Overview of OTC Derivatives Legislation

On July 21, 2010, President Obama signed into law today the Dodd-Frank Wall Street Reform and Consumer Protection Act, an historic piece of legislation that will enact the most sweeping set of rules for the financial services industry since the 1930s. Following is a summary of one of the sections of the legislation that specifically deals with regulation of over-the-counter (OTC) derivatives. The summary is intended to be used to understand the key elements of the derivatives title and can be used as a quick reference guide for market participants.

The derivatives bill ("Title VII – Wall Street Transparency and Accountability Act of 2010") is separated into two subtitles:

- Subtitle A – Regulation of Over-the-Counter Swaps Market (p. 266-379)
- Subtitle B – Regulation of Security-Based Swaps Market (p. 379-427)

The title will require many more trades to be executed on regulated exchanges and electronic trading platforms and to be centrally cleared through regulated clearinghouses. The legislation does include important exemptions from clearing, exchange trading and electronic trading for non-financial firms, but not for private funds, banks, insurance companies, or any other firm predominantly engaged in financial activities. Many of the important details will be further defined and interpreted through the regulatory rulemaking process.

The key provisions of the derivatives bill are as follows (in order of appearance):

### Broad Points:

- **Global Rulemaking Timeframe** (Sec. 712, p. 271): Not later than 360 days after the date of enactment
- **Abusive Swaps** (Sec. 714, p. 272): Gives the CFTC and SEC with the authority to collect information and issue a report on swaps they deem detrimental to the financial markets. It does not grant the regulators the authority to ban abusive swaps.
- **Authority to Prohibit Participation in Swap Activity** (Sec. 715, p. 272): Commissions may determine that the regulation of swaps markets in a foreign country undermines the stability of the US financial system and may prohibit an entity domiciled in the foreign country from participating in the US in any swap activities.
- **Prohibition Against Federal Government Bailouts of Swaps Entities** (Sec. 716, p. 273): Effectively requires banks to spin-off dealing activities into affiliated entities for product classes not permitted by the National Bank Act, including commodities/agriculture, metals (excluding gold/silver), non-cleared CDS, non-investment grade CDS, energy and equity derivatives. The provision permits banks to hedge their own risk and to retain dealing activity in interest rates, FX, cleared investment grade CDS, and gold/silver. This provision is to be implemented within two years, a timeframe that can be extended by one year. The provision enables prudential regulators to create minimum standards to conduct swap activities in a safe and sound manner. Also, a bank must be a "swap dealer" in order to be a

“swaps entity” subject to Section 716. Banks are not swap dealers to the extent they offer swaps to customers in connection with lending to those customers.

**Definitions** (Sec. 721, p. 283):

- **Eligible Contract Participants** (Sec. 721, p. 285): Municipalities must now have \$50mm in funds that they own and invest on a discretionary basis – an increase from \$25mm. Individuals must now have “total amounts invested on a discretionary basis” of \$10mm or \$5mm if swap is done for risk management purposes – a change from the same amounts of “total assets.” The eligible contract participant definition for businesses is unchanged.
- **Major Swap Participant** (Sec. 721, p. 288): Major swap participants are a special class of market participant that includes any firm that either has a substantial position of trades that are not hedges of “commercial risk,” whose derivatives activity creates substantial counterparty exposure that could harm the financial system, or is a highly-leveraged financial entity with a substantial position of derivatives. Pension plans and captive finance entities are excluded from the definition of major swap participant. The terms “substantial position” and “commercial risk” will be defined and interpreted by the CFTC.
- **Swap** (Sec. 721, p. 291): Identifies those products that would be subject to regulation as OTC derivatives. Includes FX forwards and swaps, excludes non-financial commodity transactions so long as they are intended to be physically settled.
- **Treatment of FX Swaps and Forwards** (Sec. 721, p. 293): Authorizes Treasury Secretary to exempt FX forwards and swaps from regulation, except that these trades will be subject to reporting and business conduct requirements and to fraud and manipulation provisions.
- **Swap Data Repository** (Sec. 721, p. 294): Those that collect and maintain information on swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility for swaps.
- **Swap Dealer** (Sec. 721, p. 295): Swap dealers are a special class of market participant that make a market in derivatives. In the final days of the conference committee, Congress decided to exclude depository institutions that offer swaps in connection with originating a loan with a customer. Those that do a minimal amount of swap dealing shall be exempted. The definition allows for separate consideration for dealing and hedging activities.
- **Swap Execution Facility** (Sec. 721, p. 295): Third party trading platforms that facilitate trades “through any means of interstate commerce.” The definition could include voice-brokering or electronic trading.
- **Authority to Define Terms** (Sec. 721, p. 295): CFTC may adopt a rule to define “commercial risk” and other terms included in amendments to the Commodity Exchange Act.
- **Modification of Definition** (Sec. 721, p. 295): CFTC may redefine “swap,” “swap dealer,” “major swap participant,” and “eligible contract participant” to include transactions and entities that have been structured to evade this subtitle.

**Applicability** (Sec. 722, p. 298): Provisions are not applicable to activities outside the US unless those activities have a direct and significant connection with activities in, or effect on, commerce of the United States; or contravene such rules or regulations as the CFTC may prescribe or promulgate as are necessary or appropriate to prevent evasion of any provision of the Act.

### **Clearing Requirement** (Sec. 723, p. 300):

- **Eligible contract participant** (Sec. 723, p. 300): It is unlawful for non-eligible contract participants to enter into swaps. Whether the CFTC will continue to allow firms that do not meet the asset/net worth requirements for ECP to use the “line of business” exemption to enter into swaps remains an open question.
- **Clearing Required** (Sec. 723, p. 300): It is unlawful for a person to enter into a swap unless submitted for clearing (subject to end user exception).
- **CFTC Determination** (Sec. 723, p. 302): The CFTC determines whether a swap should be required to be cleared, though clearinghouses may submit swaps to the CFTC for consideration and approval.
- **Prevention of Evasion** (Sec. 723, p. 303): The CFTC may prescribe rules to prevent evasion. If the CFTC finds a swap should be cleared and it is not listed for clearing, it can take actions it determines within the public interest, including requiring the retaining of adequate margin or capital by parties to the swap.
- **Reporting Transition** (Sec. 723, p. 304): Swaps entered into prior to enactment are not subject to clearing if reported to a swap data repository within 180 days of the effective date of the clearing requirement. Swaps entered into after enactment shall be reported 90 days after the effective date.
- **Clearing Exception** (Sec. 723, p. 304): An entity can be exempted from the clearing requirement if 1 of the parties to a swap (1) is not a financial entity, (2) is using swaps to hedge or mitigate commercial risk and (3) notifies the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps.
- **Option to Clear** (Sec. 723, p. 304): Exempt entities have the option to clear.
- **Financial Entity Definition** (Sec. 723, p. 304): The following entities are precluded from the end user exemption to clearing: swap dealers, major swap participants, commodity pools, private funds (likely including real estate opportunity funds, private equity funds and hedge funds), employee benefit plans, and persons predominantly engaged in activities that are in the business of banking or in activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956). Captive finance entities are excluded from the financial entities definition. The CFTC will decide whether to exempt banks, credit unions and farm credit institutions with \$10bn or less in assets.
- **Affiliates** (Sec. 723, p. 305): Affiliates of those that qualify for the exception can also qualify for the exception if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or affiliate of the person that is not a financial entity.
- **Prohibition Relating to Certain Affiliates** (Sec. 723, p. 305): The exception shall not apply if the affiliate is a swap dealer, major swap participant, a private fund, a commodity pool or a bank holding company with consolidated assets over \$50 billion.
- **Election of Counterparty** (Sec. 723, p. 305): End users can require counterparty to clear a trade and can choose the clearinghouse.
- **Abuse of Exceptions** (Sec. 723, p. 306): The CFTC can issue rules or interpretations to prevent abuse of the exceptions and can require information from those claiming the exception.

### **Trade Execution** (Sec. 723, p. 306):

- **Trading Requirement** (Sec. 723, p. 306): Transactions subject to the clearing requirement must be traded on a board of trade (e.g., exchange) or a swap

execution facility (e.g., third party trading platform), unless the swap is not listed on one of those venues.

- **Committee Approval** (Sec. 723, p. 306): Those that avail themselves of the clearing/trading exemption must gain review and approval to do so from their board or governing body, if they are a securities issuer under the '34 Act.
- **Segregation of Collateral for cleared trades** (Sec. 724, p. 307): Only future commission merchants (a defined class under the Commodity Exchange Act) can hold collateral for trades cleared through regulated clearinghouses. Cleared swap collateral must be segregated and not commingled.
- **Segregation of Collateral for uncleared trades** (Sec. 724, p. 309): Swap dealers must notify counterparties that they have the right to require segregation of funds. Segregation applies to initial margin, not variation margin. Segregated account to be carried by an independent third party custodian and must be designated as a separate account.

**Public Disclosure** (Sec. 725, p. 316): Clearinghouses must make the terms and conditions of each trade available to the public.

**Public Reporting of Swap Transaction Data** (Sec. 727, p. 321): All trades are subject to a real-time public reporting requirement, which shall include price and volume information on traded swaps. Non-cleared swaps must be publicly reported in a manner that does not disclose the business transactions and market positions of any person. Rules promulgated by the CFTC shall ensure publicly reported information does not identify the participants and must allow for a time delay for large trades.

**Swap Data Repository** (Sec. 728, p. 322): The CFTC will define the data elements required to be reported. The Repository must confirm with both counterparties the accuracy of the data that was submitted. The Repository must provide direct electronic access to the CFTC. The Repository must maintain the privacy of transaction information.

**Reporting and Recordkeeping** (Sec. 729, p. 326): Swaps must be reported to a swap data repository. If no swap data repository accepts the swap, the swap must be reported to the CFTC. Each swap entered into prior to enactment shall be reported to the CFTC not later than 30 days after issuance of the interim final rule or such other period as the CFTC deems appropriate. The interim final rule shall be promulgated within 90 days of the date of enactment of this section. So it appears that existing trades may be required to be reported to a repository or the CFTC not later than 120 days after President Obama signs the bill into law.

- **Reporting Obligations** (Sec. 729, p. 326): When an end user trades with a swap dealer, the swap dealer shall report the swap. When a swap dealer trades with a major swap participant, the major swap participant shall report the swap. For all other swaps, the counterparties shall select a counterparty to report the swap.

**Large Swap Trader Reporting** (Sec. 730, p. 327): If a swap performs a significant price discovery function, the CFTC can promulgate rules to limit trading, unless the person submits a report to the CFTC. Contents of the report are to be determined by the CFTC by rule.

**Registration and Regulation of Swap Dealers and Major Swap Participants** (Sec. 731, p. 328): Swap dealers and major swap participants must register with the CFTC by

filing a registration application with the CFTC. The CFTC may prescribe rules that limit the activities of swap dealers and major swap participants. Rules shall provide for registration no later than 1 year after the date of enactment.

**Capital & Margin Requirements** (Sec. 731, p. 329): Each registered swap dealer and major swap participant for which there is a prudential bank regulator (i.e., Fed, OCC, and FDIC) shall meet such minimum capital and initial & variation margin requirements as the prudential regulator shall by rule or regulation prescribe. The CFTC shall prescribe capital and margin requirements for swap dealers and major swap participants for which there is not a prudential regulator.

- **Margin** (Sec. 731, p. 330): The prudential bank regulators, in consultation with the CFTC and SEC, shall jointly adopt rules for swap dealers and major swap participants, with respect to their activities as a swap dealer or major swap participants, for which there is a prudential regulator imposing (i) capital requirements; and (ii) both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization. The CFTC shall do the same for swap dealers and major swap participants for which there is not a prudential regulator.
- **Capital** (Sec. 731, p. 330): The prudential regulator and CFTC shall take into account the risks associated with other types of swaps or classes of swaps or categories of swaps engaged in and the other activities conducted by that person that are not otherwise subject to regulation applicable to that person by virtue of the status of the person as a swap dealer or a major swap participant.
- **Standards for Capital and Margin** (Sec. 731, p. 330): To offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared, the requirements imposed shall (i) help ensure the safety and soundness of the swap dealer or major swap participant and (ii) be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant.
- **Non-Cash Collateral** (Sec. 731, p. 331): Regulators shall permit the use of noncash collateral to satisfy margin requirements.

**Business Conduct Requirements** (Sec. 731, p. 333): Business conduct standards adopted by the CFTC shall (A) establish a duty for a swap dealer or MSP to verify that any counterparty is an eligible contract participant, (B) require disclosure to any counterparty information about material risks and characteristics of the swap, any material incentives or conflicts of interest of the swap dealer or MSP and the daily mark of the transaction, (C) establish a duty for a swap dealer or major swap participant to communicate in a fair and balanced manner based on principles of fair dealing and good faith, and (D) establish such other standards and requirements as the Commission may determine are appropriate in the public interest.

**Special Requirements For Swap Dealers As Counterparties to Special Entities** (Sec. 731, p. 334): When acting as an advisor or counterparty to a Special Entity (includes government agencies, endowments and employee benefit plans), a swap dealer or MSP must comply with any duty established by the Commission that requires the swap dealer or MSP to have a reasonable basis to believe that the counterparty has an independent representative that (I) has sufficient knowledge to evaluate the transaction and risks; (II) is not subject to a statutory disqualification; (III) is independent of the swap dealer or MSP; (IV) undertakes a duty to act in the best interests of the counterparty it represents; (V)

makes appropriate disclosures; (VI) will provide written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction; and (VIII) in the case of an employee benefit plan, is a fiduciary. Also, prior to initiating the transaction they must disclose to the Special Entity in writing the capacity in which the swap dealer is acting – whether as advisor or swap dealer/counterparty. This provision shall not apply if the transaction is initiated by a Special Entity on an exchange or swap execution facility or if the swap dealer/MSP does not know the identity of the counterparty to the transaction.

**Legal Certainty** (Sec. 739, p. 354): No transaction between eligible contract participants shall be void, voidable, or unenforceable, and no party to such transaction shall be entitled to rescind, or recover any payment made with respect to the transaction solely on the failure of the transaction to meet the definition of a swap or to be cleared.

- **Legal Certainty for Long-Term Swaps Entered Into Before the Date of Enactment of the Wall Street Transparency and Accountability Act of 2010** (Sec. 739, p. 354): Unless specifically reserved in the applicable swap, neither the enactment of the Act, nor any requirement under the Act or an amendment made by the Act, shall constitute a termination event, force majeure, illegality, increased costs, regulatory change, or similar event under a swap (including any related credit support arrangement) that would permit a party to terminate, renegotiate, modify, amend, or supplement 1 or more transactions under the swap.

**Effective Date** (Sec. 754, p. 379): Unless otherwise provided, the provisions shall take effect on the later of 360 days after the date of enactment or, to the extent a provision requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provision.

The above provisions focus on “swaps” (e.g., interest rates, currencies, commodities) rather than “security-based swaps” (e.g., credit, equities). However, the provisions in each subtitle are similar.

## About Chatham Financial

Over our 20-year history, Chatham has emerged as the world's largest independent interest rate and foreign currency derivatives advisor, now advising more than 1,000 derivatives market participants.

Chatham has actively participated in the regulatory reform debate, testifying before Congress, providing policy and technical advice to the Coalition for Derivatives End-Users, educating Members of Congress and their staff, and providing advice to key Congressional committees and regulators. Additionally, Chatham will be heavily involved in the regulatory rulemaking process.

This deep derivatives market expertise and intimate knowledge of OTC derivatives regulatory requirements has ideally situated us to navigate companies through a complex new derivatives marketplace. Chatham will serve as an integral member of our clients' treasury teams by helping them understand and meet new regulatory requirements. Additionally, as market infrastructure emerges to improve transparency, trading efficiency and counterparty risk management, Chatham will help clients identify opportunities to improve treasury operations.

Chatham has launched a standalone consulting service for companies seeking to understand and adapt to new derivatives regulatory requirements.

For more information, please visit [www.ChathamFinancial.com](http://www.ChathamFinancial.com) or contact Luke Zubrod, Sam Peterson or your Chatham consultant with any questions.

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## Additional Resources

As a thought leader in OTC derivatives regulation, Chatham has authored numerous policy analyses. Several of these are linked below:

- [Chatham Proposal on OTC Reform](#)
- [Evaluating Margin Lending Facilities in the OTC Derivatives Market](#)
- [Evaluating SEFs as a Transparency Mechanism in the OTC Derivatives Market](#)
- [17 Reasons Why Clearing Should NOT Be Required for All OTC Derivatives](#)
- [Preliminary Analysis of House-Senate Conference on OTC Derivatives Title](#)
- [Financial Times Op Ed: Beware of the Mongoose](#)
- [Financial Times Op Ed: What does White House Know?](#)